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538-890—74——1

In the Supreme Court of the United States

OCTOBER TERM, 1973

No.

UNITED STATES OF AMERICA, PETITIONER

v.

BANKERS TRUST COMPANY, GIRARD TRUST COMPANY, IRVING TRUST COMPANY, MANUFACTURERS HANOVER TRUST COMPANY, MORGAN GUARANTY TRUST COMPANY OF NEW YORK, THE FIDELITY BANK, AS INDENTURE TRUSTEES

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

The Solicitor General, on behalf of the United States, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Third Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals not yet reported, is printed as Appendix A, *infra*, p. 1a, *et seq.* The orders of the district court, not officially reported, are contained in Appendix C, *infra*, p. 38a, *et seq.*

JURISDICTION

The judgment of the court of appeals (Appendix B, *infra*, pp. 36a–37a) was entered on February 6, 1974. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether, a reorganization court, acting under Section 77(o) of the Bankruptcy Act, may authorize the use of unmortgaged property to defray operating expenses after the debtor's trustees conclude that an earnings-based reorganization is not feasible by 1976, over the objection of secured creditors whose interests, the reorganization court found, are not affected.

2. Whether the statutory first lien of trustee's certificates guaranteed by the United States under the Emergency Rail Services Act of 1970, 45 U.S.C. 661, *et seq.*, may be subordinated to the claims of other secured creditors.

STATUTORY PROVISIONS INVOLVED

Sections 3(b)(3) and 3(e) of the Emergency Rail Services Act of 1970, 84 Stat. 1975–1976, 45 U.S.C. 662 (b)(3) and 662(e), provide in pertinent part:

> (b) As a condition to a guarantee, the Secretary, after consultation with the Commission, shall require that:
>
> * * * * *
>
> (3) proceeds from the sale of assets will be devoted to the fullest extent possible to the provision of essential transportation services by the railroad * * *.
>
> * * * * *

(c) The Secretary shall not guarantee any certificate unless the certificate is treated as an expense of administration and receive the highest lien on the railroad's property and priority in payment under the Bankruptcy Act. * * *.

Section 77 of the Bankruptcy Act, 49 Stat. 911, as amended, 11 U.S.C. 205, provides in pertinent part:

Section 77. Reorganization of Railroads Engaged in Interstate Commerce

(a) Petition for reorganization by railroad, subsidiary or creditors; venue; proceedings thereon; jurisdiction of court over debtor and property

Any railroad corporation may file a petition stating that it is insolvent or unable to meet its debts as they mature and that it desires to effect a plan or reorganization. * * *

* * * * *

(b) Plan of reorganization, contents; "securities," "stockholders," "creditors," "claims" defined; suspension of statutes of limitation

A plan of reorganization within the meaning of this section (1) shall include provisions modifying or altering the rights of creditors generally, or of any class of them, secured or unsecured, either through the issuance of new securities of any character or otherwise; (2) may include provisions modifying or altering the rights of stockholders generally, or of any

class of them, either through the issuance of new securities of any character, or otherwise; (3) may include, for the purpose of preserving such interests of creditors and stockholders as are not otherwise provided for, provisions for the issuance to any such creditor or stockholder of options or warrants to receive, or to subscribe for, securities of the reorganized company in such amounts and upon such terms and conditions as may be set forth in the plan; (4) shall provide for fixed charges (including fixed interest on funded debt, interest on unfunded debt, amortization of discount on funded debt, and rent for leased railroads) in such an amount that, after due consideration of the probable prospective earnings of the property in light of its earnings experience and all other relevant facts, there shall be adequate coverage of such fixed charges by the probable earnings available for the payment thereof; (5) shall provide adequate means for the execution of the plan, which may include the transfer of any interest in or control of all or any part of the property of the debtor to another corporation or corporations, the merger or consolidation of the debtor with another corporation or corporations, the retention of all or any part of the property by the debtor, the sale of all or any part of the property of the debtor either subject to or free from any lien at not less than a fair upset price, the distribution of all or any assets, or the proceeds derived from the sale thereof, among those having an interest therein, the satisfaction or modification of any liens, indentures, or other similar interests, the curing or waiver of defaults, the extension of

maturity dates of outstanding securities, the reduction in principal and/or rate of interest and alteration of other terms of such securities, the amendment of the charter of the debtor, and/or the issuance of securities of either the debtor or any such other corporation or corporations for cash, or in exchange for existing securities, or in satisfaction of claims or rights or for other appropriate purposes; and may deal with all or any part of the property of the debtor; may reject contracts of the debtor which are executory in whole or in part, including unexpired leases; and may include any other appropriate provisions not inconsistent with this section.

* * * * *

(o) ABANDONMENT OR SALE OF LINES OR PROPERTY

The trustee or trustees, from time to time, shall determine what lines or portions of lines of railroad and what other property of the debtor, if any, should be abandoned or sold during the pendency of the proceedings in the interest of the debtor's estate and of ultimate reorganization but without unduly or adversely affecting the public interest, and shall present to the judge petitions, in which other parties in interest may join, for authority to abandon or to sell any such property; and upon order of the judge made after a hearing pursuant to such reasonable notice by publication or otherwise as the judge may direct to parties in interest, authorizing any such abandonment or sale, but only with the approval and authoriza-

tion of the Commission when required by the Interstate Commerce Act, as amended February 28, 1920, or as it may be hereafter amended, the trustee or trustees shall take all steps and carry out all proceedings necessary for the consummation of any such abandonment or sale in accordance with the order of the judge. Any such order of the judge shall be a final order for the purposes of appeal. The judge may order and decree any sale of property, whether or not incident to an abandonment, under this subsection at public or private sale and subject to or free from liens. The proceeds derived from any such sales shall be received by the trustee or trustees subject, in case the property was sold free from lien, to any liens thereon at the time of sale, and shall be applied or disposed of in such manner as the judge by further order shall direct. The expense of such sale shall be borne in such manner as the judge may determine to be equitable. The judge may order the trustee or trustees of the debtor to deposit such proceeds with any mortgage trustee entitled thereto, to be applied in payment of all or part of such mortgage.

STATEMENT

In June, 1970, the Penn Central Transportation Company, the largest railroad in the United States, entered reorganization under Section 77 of the Bankruptcy Act, 11 U.S.C. 205. During the next two and one-half years, Penn Central continued its deficit rail operations while its trustees attempted to achieve conditions permitting a successful reorganization.

During the first quarter of 1973, three events occurred that gave rise to the present action: (1) On January 1, 1973, the Penn Central trustees reported for the first time that a traditional earnings-based reorganization was not feasible by 1976 without government grants for plant improvements (J.A. 155a).[1] (2) Congress began an intensive effort to enact a comprehensive statute designed to consolidate and rehabilitate rail service operated by the then seven bankrupt Northeast railroads.[2] (3) Penn Central experienced a liquidity crisis which threatened to interrupt its rail operations (App. A, *infra*, p. 3a; J.A. 16a, 217a, 243a–252a). To meet this crisis, the Penn Central trustees sought permission from the reorganization court to sell certain unmortgaged realty, and securities acquired by the railroad before bankruptcy to pay contingent compensation to its executives upon their retirement, and to use the proceeds to preserve operations.

Respondents, as indenture trustees for the bondholders, objected, on the grounds (1) that, after the Penn Central trustees' January 1, 1973 report, any

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[1] "J.A." is the Joint Appendix in the Court of Appeals which is being lodged with the Court.

[2] On February 8, 1973, Congress passed S.J. Res. 59, 93d Cong., 1st Sess., Section 2 of which directed the Secretary of Transportation to provide within 45 days "a full and comprehensive plan for the preservation of essential rail transportation services in the Northeast * * *." This effort produced the Regional Rail Reorganization Act of 1973, P.L. 93-236, 87 Stat. 985, January 2, 1974. The seven bankrupt carriers were: Penn Central, Lehigh Valley, Reading, Central of New Jersey, Erie Lackawanna, Boston & Maine, and Lehigh and Hudson River. An eighth, Ann Arbor, entered Section 77 proceedings in November, 1973.

further use of capital assets, mortgaged or unmortgaged, to sustain deficit rail operations was confiscatory absent a "firm assurance" of a successful income-based reorganization of the railroad (App. C, *infra*, p. 39a), and (2) that, if such use of unmortgaged capital assets was permitted, the reorganization court should marshal (*i.e.*, reduce) the first lien of the $100 million trustees certificates guaranteed by the United States under the Emergency Rail Services Act of 1970, 45 U.S.C. 661, *et seq.*, on mortgaged property to the extent of the unmortgaged property consumed in operations (*ibid.*).[3]

The district court granted the trustees' petitions, Orders 1073, 1087–1088, 1103, and 1156 (App. C, *infra*, pp. 38a–71a). The court rejected the bondholders' arguments, finding no basis in the record for the "morbid conjecture" that, even on a liquidation basis, the Penn Central estate would be insufficient to cover all valid administration claims and the bondholders' secured debt (App. C, *infra*, p. 41a). The court based its approval of the trustees' petitions in part on Section 3(b)(3) of the Emergency Rail Services Act of 1970, 45 U.S.C.

[3] Congress passed the Emergency Rail Services Act of 1970 to alleviate a Penn Central liquidity crisis which occurred soon after bankruptcy. See Statement of Senator Cotton, 116 Cong. Rec. 44066 (1970). The Act allowed the Secretary of Transportation to guarantee up to $125 million in trustees' certificates of bankrupt railroads, provided that the certificates were awarded the status of an administration expense and a first-lien on all of the railroad's property, 45 U.S.C. 662(c), and required that the railroad devote the proceeds of sales of its own assets "to the fullest extent possible" to the provision of essential transportation services, 45 U.S.C. 662(b)(3). Penn Central issued $100 million in trustees certificates guaranteed under the Act.

662(b)(3), which requires proceeds from the sales of assets to be used "to the fullest extent possible" for the provision of essential transportation services (App. C, *infra*, p. 65a). The bondholders appealed.[4]

The court of appeals reversed. That court held, first, that because the "economic effect" of the expenditures was to reduce the amount of unsecured property otherwise available to satisfy the government's first lien on the property of the bondholders, the sale was precisely the same as if secured property of the bondholders was itself being expended (App. A, *infra*, p. 16a). Looking to this "fact" rather than to "form" (*ibid.*), in spite of the fact that there is no evidence that the assets of the railroad are inadequate to meet all administration claims, the court held, second, that such expenditures could not be made without findings by the reorganization court, which it viewed as constitutionally required, that (a) a reorganization is feasible, and (b) there is a high likelihood that secured creditors will not be injured by the expenditures (App. A, *infra*, p. 17a). Third, the court held that if the United States, as a holder of a first lien on all of the debtor's assets, secured and unsecured, consented to any expenditures absent such findings, its lien should be reduced in the amount of such expenditures (App. A, *infra*, pp. 28a–29a). Because the reorganization court had not made the required findings, the court of appeals reversed the orders authorizing the expenditures. The court took

[4] $87.4 million, all drawn from the contingent compensation fund, has been expended. The proceeds from the sales of unmortgaged realty remain in escrow accounts (App. A, *infra*, pp. 3a–6a).

judicial notice of the Regional Rail Reorganization Act of 1973, but said that "such judicial notice cannot serve to enlarge the power of the reorganization court and the ICC to subject the property of secured creditors to a taking while, like Mr. Micawber, they wait for something to turn up" (App. A, *infra*, pp. 26a–28a). The court remanded the case to the district court for a determination of whether the United States had consented to the expenditure.

REASONS FOR GRANTING THE WRIT

1. The court of appeals' decision significantly limits the flexibility available to a reorganization court in conducting the reorganization of a large railroad providing vital public services. The satisfactory completion of that reorganization in a fashion consistent with the rights of creditors and the public interest normally requires that the railroad continue to operate while the steps necessary to achieve such a reorganization are taken by local, state, or federal legislative or regulatory bodies. If a railroad such as the Penn Central cannot draw on its own assets to meet short term cash needs unless reorganization under the statute alone is feasible, the trustees and the reorganization court will, if faced with inadequate cash resources, be unable to preserve its operations while taking steps to work out a satisfactory reorganization by other means. Ironically, the court of appeals' action limiting the authority of the reorganization court resulted in part because the plight of the debtor was of such national concern that Congress determined that it should be provided with assistance in the form of a

government guarantee of its trustees' certificates,[5] effectively reducing the interest rate it would have otherwise been required to pay.

The court of appeals relied on two lines of authority to reach this result.

(a) First, it applied the doctrine of *In re Third Avenue Transit Corp.*, 198 F. 2d 703 (C.A. 2), and *Central Railroad Co. of New Jersey* v. *Manufacturers Hanover Trust Co.*, 421 F. 2d 604 (C.A. 3) certiorari denied *sub nom. Federal Trustee* v. *Manufacturers Hanover Trust Co., Trustee*, 398 U.S. 949 (App. A, *infra*, pp. 11a–14a, 16a–17a). These cases deal with the question of when assets of the estate subject to a security interest can be sold and the proceeds used not to reduce the indebtedness secured by the assets but for the general benefit of the estate. The Second and Third Circuits held that a reorganization court may not constitutionally take this extraordinary step unless it makes certain findings.

These findings were summarized in *Third Avenue* as follows:

> But we believe that that power should never be exercised absent findings, based on the clearest evidence, not only that it is imperative to obtain

[5] The court of appeals explicitly relied on the existence of the lien arising out of this guarantee under Section 3(e) of the Emergency Rail Services Act of 1970, 45 U.S.C. 662(e). Respondents may argue that the decision below rests on the existence of this special statutory provision and thus presents a situation unlikely to recur. However, the government's lien is no different from that possessed by trustees' certificates or other obligations incurred in the process of administration in any reorganization and thus the theory of the court of appeals would be applicable in all railroad reorganizations. See Bankruptcy Act, section 64(a), 52 Stat. 874, as amended, 11 U.S.C. § 104(a).

> the funds and that they cannot be obtained, on reasonable terms, first, by bank loans or second, by the disposal of certificates under Section 116, sub. 2, through ordinary market channels to voluntary lenders, but also that there is a high degree of likelihood (a) that the debtor can be reorganized in accordance with the Act, within a reasonable time, and (b) that the secured creditors whose security is being compulsorily loaned will not be injured. The reorganization trustees here had the burden of proving all these matters. [198 F. 2d at 706–707; footnotes omitted.]

The theory of *Third Avenue* is that such sale can be made even though it destroys the very security to which the secured creditor is entitled and the proceeds are used for the benefit of creditors having lesser priority, because the findings assure that the sale is consistent with the ultimate preservation of the value of the secured creditor's rights.

The court of appeals extended the *Third Avenue* principle to this case even though the property involved was unsecured and subject to no special claim of the objecting bondholders. The court held the *Third Avenue* doctrine applicable because "[l]ooking to fact rather than to form, then, the same fundamental constitutional prohibition against uncompensated takings should apply" (App. A, *infra*, p. 16a). The sole "fact" on which the court relied was that the sale of these assets and the use of the proceeds to defray operating expenses would reduce the total amount of assets available to satisfy the liens of the United States and others aris-

ing out of the administration of the bankrupt having rights superior to those of the bondholders.

But absent a demonstration by the bondholders that the assets of the estate are not sufficient to satisfy all such claims, this is not a "fact" but merely a speculative possibility. The district court specifically found that it was only a "morbid conjecture" (App. C, *infra*, p. 41a).

(b) The court of appeals also relied on a line of decisions by this Court dealing with the constitutional limitations on the power of a legislature, regulatory agency, or court to compel continuing loss operations by the debtor (App. A, *infra*, pp. 17a–26a). The court principally relied on *Brooks-Scanlon Co.* v. *Railroad Commission*, 251 U.S. 396. No decision could be more inapposite.

That case involved the plight of a small railroad principally hauling lumber products which became hopelessly insolvent after the forest it served was chopped down. With no other present or prospective sources of traffic, it was reasonably certain to operate at a perpetual loss. It had nevertheless been ordered to continue operating—not so that a reasonable solution to its difficulties could be arranged but simply so that the public could continue to enjoy its service at the expense of its owner. The Court held that such continued operation could not be required.

In contrast, the debtor here possesses franchises to provide a vital public service to a large and prosperous area of the country. Its difficulties have been a matter of national concern. It has received government financial assistance. A special statute has been

enacted to provide for its reorganization together with other bankrupt lines in the region in a manner consistent both with the rights of creditors and the public interest, and the complex but expedited statutory procedures have begun.

This Court has itself recognized that in a reorganization of a railroad of this type more is involved than the question of whether it can, by itself and without changes in its structure, be reorganized on an earnings basis. In the *New Haven Inclusion Cases*, 399 U.S. 392, this Court said that secured creditors were not entitled to compensation for losses incurred during the period necessary to effect a reorganization, not on an earnings basis but on the basis of a merger with another railroad. 399 U.S. 489–492. There this Court relied heavily on *Reconstruction Finance Corp.* v. *Denver & R.G.W. R. Co.*, 328 U.S. 495. The pertinent passage from that decision, which the court of appeals ignored, is as follows:

> [Security holders] cannot be called upon to sacrifice their property so that a depression-proof railroad system might be created. But they invested their capital in a public utility that does owe an obligation to the public * * *. [B]y their entry into a railroad enterprise, [they] assumed the risk that in any depression or any reorganization the interests of the public would be considered as well as theirs. [399 U.S. 491–492.]

The decision of the court of appeals effectively alters the structure of Section 77. Section 77 recognizes that there are situations where it is inappropri-

ate to continue a reorganization of an insolvent railroad. Section 77(g), 11 U.S.C. 205(g), provides that any party in interest may file a motion to dismiss the reorganization. This has been done here in the reorganization court and a hearing on the petition was held on May 6, 1974. What the court of appeals has effectively done is to require that in the face of a short term cash shortage the railroad not draw on its own assets but—since it will be the only alternative—curtail or terminate service even though the orderly procedure provided to enable the reorganization court to address the issue of whether such termination is appropriate has not been followed. As the reorganization court was told on January 10, 1973, before it approved these expenditures, "[i]f nothing happens to improve the cash picture, we would have to start planning a shutdown * * * about the middle of February" (J.A. 251a).

2. The decision of the court of appeals effectively frustrates an explicit statutory command. Section 3(b)(3) of the Emergency Rail Services Act of 1970, 45 U.S.C. 662(b)(3), provides that "proceeds from the sale of assets [of a railroad receiving assistance under this act, as this railroad has] will be devoted to the fullest extent possible to the provision of essential transportation services of the railroad * * *." This provision reflects a policy of the Congress that assets acquired during the many profitable years of operation of transportation services should not now be un-

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available to assist the railroad in providing those services. By holding, on constitutional grounds, that unsecured assets cannot now be used by the debtor to defray operating losses, the court of appeals has in effect invalidated this directive.

3. The holding of the court of appeals that the lien of the United States on the property subject to the security of the bondholders must be reduced under the rules of marshaling by the amount of the expenditures to which it has consented is in direct contravention of Section 3(c) of the Emergency Rail Services Act of 1970, 45 U.S.C. 662(c), which provides for such an absolute lien. Nowhere in the text of that act is there any suggestion that that lien is subject to modification by equitable principles of marshaling.

CONCLUSION

For the reasons stated above, the petition for a writ of certiorari should be granted.

Respectfully submitted.

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MAY 1974.

APPENDIX A

United States Court of Appeals For the Third Circuit
Nos. 73-1260, 73-1271-79, 73-1286-87, 73-1299,
73-1414-15

In the Matter of:

PENN CENTRAL TRANSPORTATION COMPANY, DEBTOR
GIRARD TRUST BANK, APPELLANT IN NOS. 73-1260, 73-1274 AND 73-1276
BANKERS TRUST COMPANY, APPELLANT IN NOS. 73-1271, 73-1299 AND 73-1414
MANUFACTURERS HANOVER TRUST, APPELLANT IN NOS. 73-1272, 73-1279 AND 73-1415
THE FIDELITY BANK, APPELLANT IN NOS. 73-1272, 73-1279 AND 73-1415
IRVING TRUST COMPANY, APPELLANT IN NOS. 73-1273, 73-1278 AND 73-1286
MORGAN GUARANTY TRUST COMPANY OF NEW YORK, APPELLANT IN NOS. 73-1275, 73-1277 AND 73-1287

(D.C. No. 70-347 In Bankruptcy)

Appeal From the United States District Court for the Eastern District of Pennsylvania

Argued October 26, 1973

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OPINION OF THE COURT

(Filed February 6, 1974)

GIBBONS, *Circuit Judge:* This is an appeal, pursuant to Section 77(o) of the Bankruptcy Act, 11 U.S.C. § 205(o),[1] from five orders of the reorganization court authorizing the sale of separate properties of the debtor Penn Central Transportation Company. The orders resulted from four separate petitions by the trustees in reorganization. Each petition was prompted by the cash shortage projected by the trustees for the first quarter of 1973. The orders and the underlying petitions are summarized as follows:

[1] "Any such order of the judge shall be a final order for the purposes of appeal." 11 U.S.C. § 205(o).

ORDER NO. 1073

In a petition dated November 20, 1972 the trustees requested authority to grant, for $10,000, a six-month option to purchase, for $825,000, 4.399 acres of the debtor's subproductive nonrail real estate in Columbus, Ohio. The trustees proposed to use the net proceeds, after the payment of back real estate taxes and expenses of sale, to reimburse the general operating funds of the debtor. Order No. 1073 granted the petition and allowed the trustees, in the event the option was exercised, to reimburse general operating funds "for additions and betterments previously or hereafter made on unmortgaged property owned by the Trustees." The Columbus, Ohio property is not subject to any mortgage indenture but is subject to the lien of the United States securing trustees certificates issued pursuant to reorganization court Order No. 124 and Section 3 of the Emergency Rail Services Act of 1970, 45 U.S.C. § 662. At the time of argument of the appeal the option had not yet been exercised. The original option date had expired but had been extended. *See* Order No. 1330 (Sept. 28, 1973).

ORDER NO. 1103

In a petition dated December 11, 1972 the trustees requested authority to sell a note owned by the debtor and secured by a second mortgage on real estate in Philadelphia, Pennsylvania, on which stands the Penn Towers office and apartment building, and receive the proceeds for general operating expenses. The unpaid principal of this note on December 11, 1972 was $1,750,000 and there was unpaid interest in the amount of $971,250. The note is not subject to any mortgage indenture or similar security interest but is subject to the lien of the United States securing trustees cer-

tificates issued pursuant to Order No. 124 and Section 3 of the Emergency Rail Services Act of 1970. Order No. 1103 authorized the sale for $2,721,250 and ordered that the net proceeds "be deposited in a general cash account of the Trustees and devoted to the fullest extent possible to the payment of expenses, which if not met would preclude the continued provision of essential transportation services"; that is, to general operating expenses. At the time of argument of the appeal the closing on the sale of the note had not yet taken place.

ORDERS NO. 1087, 1088

In a petition dated December 26, 1972 the trustees requested authority to liquidate $10,000,000 in securities held by the debtor as a part of its Contingent Compensation Reserve Fund and to use the proceeds for general operating expenses. The Fund is not subject to any mortgage indenture or similar security interest,[2] but is subject to the lien of the United States securing trustees certificates issued pursuant to Order No. 124 and Section 3 of the Emergency Rail Services Act of 1970. Orders No. 1087 and 1088 authorized the liquidation of $7,400,000 in securities from the Fund and the use of the proceeds to "meet current operating expenses." At the time of argument of the appeal the Fund had been liquidated and the proceeds dissipated in the trustees' general operations.

[2] Several former employees who were participants in the Contingent Compensation Plan under which the Fund was established objected to the sale. Their objections were considered by the court in *In re Penn Central Transportation Company*, 484 F. 2d 1300 (3d Cir. 1973), *petitions for cert. filed*, 42 U.S.L.W. 3379 (U.S. Dec. 21, 1973) (No. 73-964), and 42 U.S.L.W. 3406 (U.S. Jan. 2, 1974) (No. 73-1039). We held that the employees did not have a secured interest in the Fund.

ORDER NO. 1156

In a petition dated February 22, 1973 the trustees requested authority to sell 16.984 acres of nonrail real estate located in Toledo, Ohio for $134,173, and to use the net proceeds, after payment of selling expenses and back taxes, to reimburse their general operating funds. The Toledo, Ohio property was not subject to any mortgage indenture, but was subject to the lien of the United States for trustees certificates issued pursuant to Order No. 124 and Section 3 of the Emergency Rail Services Act of 1970. Order No. 1156 authorized the sale and provided that the proceeds "shall be kept in a special account and used by the Trustees to reimburse their general funds for additions and betterments previously or hereafter made on unmortgaged property owned by the Trustees." At the time of argument of the appeal the closing had taken place and the proceeds remained in the special account.

STANDING OF THE APPELLANTS

The several mortgage indenture trustees represent the bulk of the debtor's preorganization secured creditors. None of the property subject to the orders appealed from is covered by their indentures. All of the property subject to those orders, however, prior to the entry of those orders, secured the post-reorganization trustees certificates. By virtue of Order No. 124's implementation of Section 77 (c)(3) of the Bankruptcy Act and Section 3(c) of the Emergency Rail Services Act of 1970, all the property subject to the mortgage indentures is also subject to the prior lien of the trustees certificates, as well as to the payment of other expenses of administration as priority claims. They urge that the sale of unmortgaged capital assets subject to the lien of the trustees certificates, without

any application of the proceeds in reduction of that lien, results in an increase in the burden of prior secured debt to which the mortgaged properties securing their claims is subjected. Thus they are directly affected by the orders appealed from. They object to the sale of unmortgaged capital assets securing prior liens unless (1) the proceeds of sale are applied in reduction of those liens, or (2) under the equitable rule of marshaling the prior liens are reduced pro tanto, or (3) the court, before it permits expenditure of the proceeds, makes the findings required for a section 77(o) sale by *Central Railroad Co. of New Jersey v. Manufacturers Hanover Trust Co.*, 421 F.2d 604 (3d Cir.), *cert. denied*, 398 U.S. 949 (1970) (*Jersey Central*) and *In re Third Avenue Transit Corp.*, 198 F.2d 703 (2d Cir. 1952) (*Third Avenue*).

THE TRUSTEES' POSITION ON APPEALABILITY

The trustees would prefer not to have the appeal decided. They urge that since the proceeds of sale under Orders No. 1073, 1103 and 1156 have not yet been spent we should treat these orders as nonfinal under 11 U.S.C. § 205(o). This would be a strained construction of that subsection. The subsection permits the judge to order a sale of assets "in the interest of the debtor's estate and of ultimate reorganization".[3] It goes on to provide "[a]ny such order of the judge shall be a final order for the purposes of appeal." There is no question but that each of the orders in issue is "such order of the judge." The trustees suggest that the statutory

[3] There is no contention that these sales were not in the interest of ultimate reorganization. *Compare* this *with In re Penn Central Transportation Co.*, 484 F.2d 323 (3d Cir. 1973), *cert. denied*, 42 U.S.L.W. 3334–35 (U.S. Dec. 3, 1973) (*Park Avenue Properties*).

language can be avoided by their tendered stipulation with respect to the proceeds of sale under Orders No. 1073, 1103 and 1156 that these proceeds will not be expended without a further order of the district court. Here, again, the internal structure of section 77(o) stands in the way of treating the orders as nonfinal, for after setting forth that "such order of the judge shall be a final order" the subsection goes on to provide:

> The proceeds derived from any such sales shall be received by the trustee . . . and shall be applied or disposed of in such manner as the judge by further order shall direct.

It is clear, therefore, that neither the fact that the proceeds under Orders No. 1073, 1103 and 1156 are unspent nor the fact that the trustees are willing to subject those proceeds to a further order of the reorganization court takes those orders out of the category of final orders reviewable under § 77(o).

The trustees position with respect to Orders No. 1087 and 1088 obviously is different, since the proceeds of sale of the securities in the Contingent Compensation Reserve Fund have been received and expended. Conceding that these orders are final, the trustees urge that we should nevertheless postpone decision on the issues raised by the appeal of the indenture trustees. They contend that we should not consider whether the proceeds should have been applied to reduce prior liens, whether the marshaling rule is applicable, or whether the debtor's capital assets should be restored pending appropriate *Jersey Central* or *Third Avenue* determinations, because these issues can be dealt with in a plan of reorganization. For authority the trustees rely on *In re Penn Central Transportation Company*, 484 F. 2d 323 (3d Cir. 1973), *cert. denied*, 42 U.S.L.W. 3334–35 (U.S. Dec. 3, 1973) (*Park Avenue Properties*).

The trustees misapprehend the thrust of the decision relied on. In that case we affirmed the reorganization court's holding that income from pledged shares was available to the trustees and need not be paid over to the pledgee, but we prohibited the sale, pursuant to § 77(o), of the underlying properities. The fundamental attack in the *Park Avenue Properties* appeal was on the extent of the court's power under § 77(o), and that issue was decided, not postponed. The appeal did not present the issue of use of the proceeds, since we prohibited the sales. A plan of reorganization cannot restore assets lost to the estate in deficit operations.

Finally, the trustees urge that at least with respect to Orders No. 1073, 1103 and 1156, assuming appealability, we should superimpose on § 77(o) a ripeness doctrine, and in view of their tendered stipulation that they will not spend the proceeds of sale of properties covered by these orders without a further court order, decline to decide the appeal until such order is entered. Putting aside the question whether we could legally contract our statutory appellate jurisdiction by inventing a ripeness doctrine, there is no reason for doing so in this case. If the district court did not believe the proceeds of sale could be used as proposed, it might not have authorized the sale at all. While the mortgagee appellants may be happy to have the lien of the trustees certificates secured by cash proceeds rather than by real estate or securities, the trustees may feel that if they cannot use the proceeds of sale of these real estate assets the sale is not provident at this time. Moreover, any analytical justification for contracting a grant of appellate jurisdiction by the invention of a ripeness doctrine must be found in some principle of appellate self-protection which avoids the necessity for pronouncing the law pre-

maturely or unnecessarily. Since we must in any event review Orders No. 1087 and 1088, no self-protective principle is operative here. Rather we would be deciding, unnecessarily and prematurely, that the grant of appellate jurisdiction in § 77(o) could be limited by a ripeness doctrine.

In sum, we see no legitimate route by which we can avoid decision of the issues tendered by this appeal. That, incidentally, is the position on appealability of the United States as appellee.

THE UNITED STATES POSITION ON THE MERITS

The United States acknowledges that by resorting to first lien trustees certificates the trustees operating a railroad in reorganization can accomplish a substantial diminution of the security of the railroad's secured creditors, but urges

> (1) that such result violates neither section 77 nor the fifth amendment,
>
> (2) that its first lien is not, under the Emergency Rail Services Act of 1970, subject to the marshaling rule, and that the marshaling rule is not constitutionally required, and
>
> (3) that the principles of the *Jersey Central* and *Third Avenue* cases are applicable only to property mortgaged by the debtor to the protesting creditor.

Chief reliance for these positions is placed upon the *Penn-Central Merger Cases*, 389 U.S. 486 (1968) and the *New Haven Inclusion Cases*, 399 U.S. 392 (1970).

THE TRUSTEES' POSITION ON THE MERITS

The trustees' position, while stated in terms of a reasonable exercise of the reorganization court's discretion, is essentially the same as that of the United States.

THE THIRD AVENUE-JERSEY CENTRAL RULES

In exercising the power granted by § 77(o) to convert capital assets to cash the reorganization court must act within the bounds of the fifth amendment; that is, the court may not by the device of a § 77(o) sale authorize an unconstitutional taking of property of mortgage bondholders. The outer limits of constitutionality have been suggested in two tests, applicable in different circumstances. We have endorsed the test laid down in *In re Third Avenue Transit Corp.*, 198 F. 2d 703 (2d Cir. 1952).[4] We have also endorsed the test laid down in *In re New York, New Haven & Hartford Railroad*, No. 30226 (D. Conn. December 7, 1961) and stated for this court in *Central Railroad Co. of New Jersey v. Manufacturers Hanover Trust Co., supra. See In re Penn Central Transportation Co.*, 474 F. 2d 832, 835–36 (3d Cir. 1973) (*Selkirk Yard*). These cases restrict the application of proceeds of a § 77(o) sale in order to protect mortgage bondholders. They provide the standards which the reorganization court must apply in ordering application or disposition of § 77(o) sale proceeds.

Third Avenue concerned subsidizing operations by the use of proceeds held by the indenture trustee from the sale of mortgaged assets. To protect secured creditors from being forced unconstitutionally to invest their liquid security in a bankrupt enterprise, the Court held:

> "But we believe that the power should never be exercised absent findings, based on the clearest evidence, not only that it is imperative to obtain

[4] *Third Avenue* was actually a Chapter X rather than a § 77 reorganization, but the fifth amendment is equally applicable to both proceedings, and in *Jersey Central* we have considered *Third Avenue* to be applicable in railroad reorganizations.

> the funds and that they cannot be obtained, on reasonable terms, first, by bank loans or second, by the disposal of certificates under Section 116, sub.2, through ordinary market channels to voluntary lenders, but also that there is a high degree of likelihood (a) that the debtor can be reorganized in accordance with the Act, within a reasonable time, and (b) that the secured creditors whose security is being compulsorily loaned will not be injured. The reorganization trustees here had the burden of proving all these matters." 198 F.2d at 706–07 (footnotes omitted).

No one contends that the trustees could have obtained funds for operating purposes through ordinary market channels. Thus we can assume that the unavailability feature of the *Third Avenue* test has been met. The remaining mandatory findings, (a) a high degree of likelihood of reorganization within a reasonable time, and (b) a high degree of likelihood that secured creditors will not be injured, were not made by the reorganization court with respect to any of the orders appealed from. Indeed on the record before the reorganization court no such findings could have been made. Orders No. 1103, 1087 and 1088 all provided that the proceeds of sale could be expended for the railroad's general operations. Thus if the *Third Avenue* test applies to them, the requisite findings have not been made and the orders would be invalid.

In *Jersey Central* we said that a less strict set of findings were required when the proceeds of a sale or prior encumbrance of mortgaged assets were to be used to make additions and betterments to properties covered by the mortgage rather than expended in operations.

> "'The rule for a reorganization under Sec. 77 * * * is that [1] in addition to finding that the funds are presently needed and cannot be ob-

> tained elsewhere [2] the court need only conclude that reorganization is probably feasible, [3] that the money drawn-down and expended for additions and betterments will materially contribute to the possibility of successful reorganization and to the continuation of the transportation plant, or a substantial part thereof, as a going concern, and [4] that the interests of the bondholders are not thereby prejudiced.' " 421 F. 2d at 606.

The chief difference between the two tests is that if additions and betterments are to be made to the mortgaged property (*Jersey Central*) the reorganization court need only find that reorganization is probably feasible, while if the proceeds of the draw-down are to be expended other than for additions and betterments to the mortgaged properties (*Third Avenue*), it must find a high degree of likelihood that the debtor can be reorganized in a reasonable time. Both tests require findings that the mortgagees not, by the expenditure, be prejudiced. The finding of lack of prejudice under *Jersey Central* involves a determination that the plant subject to the superior lien is worth no less after the additions and betterments than before the sale and reinvestment. A finding of lack of prejudice under *Third Avenue* involves a firm prediction that in a capitalized earnings plan of reorganization or in liquidation the plant subject to the mortgage will be valued so as to pay the secured creditor at least as much as if the lien of the trustees certificates had not been imposed.

Orders No. 1073 and 1156 provide that the proceeds may be used to reimburse general operating funds "for additions and betterments previously or hereafter made on unmortgaged property." The quoted language would seem, on the surface, to take these orders out of the less stringent *Jersey Central* test,

and put them within *Third Avenue,* assuming either test applies. Arguably, however, since the appellants' standing depends upon the effect on their security of releasing unmortgaged assets from the lien of the trustees certificates, no more should be required to put these orders within *Jersey Central* than expenditures for additions and betterments subject to that lien. In any event, no *Jersey Central* findings were made with respect to either order.

THE MARSHALING RULE

The lien securing the government's guarantee of the trustees certificates is a first lien on all the debtor's assets mortgaged and unmortgaged alike, the government's position vis-à-vis the beneficiaries of the mortgage indentures is that of superior lienholder and junior encumbrancer, with the superior lienholder having other security. Such a situation ordinarily brings into operation the equitable rule that the superior lienholder may not release the other security and thereby prejudice the junior encumbrancer. One court has stated the rule thus:

> Under established equitable principles, the junior encumbrancer is entitled to have the proceeds of the sale of mortgaged property applied upon the senior indebtedness, whether the property sold was covered by the mortgage or not. And if the senior mortgagee, with actual knowledge of the junior encumbrance voluntarily releases a portion of its security to the prejudice of the junior encumbrancer without releasing a proportionate part of its debt, it is accountable to the junior encumbrancer for the value of the released security. *Continental Supply Co. v. Marshall,* 152 F. 2d 300, 308 (10th Cir. 1945), *cert. denied,* 327 U.S. 803 (1946).

The government contends that any duty it might have had toward junior encumbrancers by virtue of its position as a superior lienholder was eliminated by § 3(c) of the Emergency Rail Services Act of 1970, 45 U.S.C. § 662(c), which provides:

> The Secretary shall not guarantee any certificate unless the certificate is treated as an expense of administration and receive the highest lien on the railroad's property and priority in payment under the Bankruptcy Act.

The government also relies upon § 3(b) of that Act:

> As a condition to a guarantee, the Secretary, after consultation with the Commission shall require that
>
> (1) the proceeds of the sale of certificates guaranteed under this chapter will be used solely for meeting payroll and other expenses which, if not met, would preclude continued provision of essential transportation services by the railroad;
>
> * * * * *
>
> (3) proceeds from the sale of assets will be devoted to the fullest extent possible to the provision of essential transportation services by the railroad; . . .

Under the government's interpretation of the Act it, as a superior lienholder, is required to permit the sale of all of the debtor's unmortgaged capital assets and the application of the proceeds thereof for deficit operation of the railroad even if this means that junior encumbrancers must ultimately bear the entire costs of the trustees certificates. The appellants urge that Congress never intended such a result. Rather, they urge, the Emergency Rail Services Act of 1970, properly construed, (a) requires proper *Third Avenue* findings prior to the resort to government-assisted borrowing, and (b) makes no change in the duty of the

superior lienholder toward junior encumbrancers. Any other construction, they urge, would run afoul of the fifth amendment taking clause.

THE ECONOMIC EFFECT OF THE ORDERS

Because the government's guarantee of the trustees certificates is secured by a first lien on all the debtor's assets, mortgaged as well as unmortgaged, the effect of the sale of unmortgaged assets and the expenditure of the proceeds thereof, unless the marshaling rule applies, is to increase the burden of the government's lien on the mortgaged assets. This is identical in economic effect to the issuance of new trustees certificates secured by a prior lien on the mortgaged assets and the expenditure of the proceeds in the operation of the debtor's business or for additions and betterments. When such trustees certificates were issued in this case the reorganization court assumed that the constitutional prohibition against uncompensated takings applied and that findings similar to those required by *Third Avenue* and *Jersey Central* must be made. *See In re Penn Central Transportation Co.*, 325 F. Supp. 302, 304 (E.D. Pa. 1971). Looking to fact rather than to form, then, the same fundamental constitutional prohibition against uncompensated takings should apply.[5] If, as the government contends, the *New Haven Inclusion Cases* authorize a different result, then these cases must be deemed to have overruled *Third Avenue* and *Jersey Central*.[6] Certainly we did not think that *Third Avenue* and *Jersey Central* lacked current authority when we decided *In re*

[5] *See* note 7 *infra*. A creditor who is fully secured may, of course, lack standing to assert an injury to stockholders or less secure creditors.

[6] *Jersey Central* was decided in January 1970. The *New Haven Inclusion Cases* were not decided until June 29, 1970.

Penn Central Transportation Co. (Selkirk Yard), supra, or *In re Penn Central Transportation Co.,* 468 F. 2d 1222 (3d Cir. 1972) (*Mortgage Releases*). In the *Selkirk Yard* case we found that the reorganization court had correctly applied the *Jersey Central* test. Thus technically we were not called upon to consider whether it had been overruled by the *New Haven Inclusion Cases.* In the *Mortgage Releases* case, however, we held that *Jersey Central* findings were required before a mortgagee could be compelled to release mortgaged property in exchange for additions and betterments.

THE FIFTH AMENDMENT MINIMUM REQUIREMENTS

In *Brooks-Scanlon Co.* v. *Railroad Commission,* 251 U.S. 396 (1920) the Court unanimously invalidated an order of a state railroad commission which required an intrastate railroad to continue operation on specified schedules at a loss. So long as the railroad repudiated its railroad charter and common carrier business, the Court held, the owners had a right to withdraw their capital from a losing venture. In *Railroad Commission* v. *Eastern Texas Railroad,* 264 U.S. 79, 85 (1924), again in a state regulatory context, the Court affirmed the *Brooks-Scanlon* rule stating:

> "The company, although devoting its property to the use of the public, does not do so irrevocably or absolutely, but on condition that the public shall supply sufficient traffic on a reasonable rate basis to yield a fair return. And if at any time it develops with reasonable certainty that future operation must be at a loss, the company may discontinue operation and get what it can out of the property by dismantling the road. *To compel it to go on at a loss or to give up the salvage value would be to take its property without the just compensation which*

is a part of due process of law." (Emphasis added)

See also Bullock v. *Florida ex rel. Railroad Commission*, 254 U.S. 513, 521 (1921). The *Brooks-Scanlon, Eastern Texas* and *Bullock* cases all arose in a fourteenth amendment context since all involved state rather than federal action. But they are applicable, a fortiori, to federal action, assuming they have not been overruled, since the fifth amendment, unlike the fourteenth, contains an express prohibition against unconstitutional takings. Congressional power under either the bankruptcy clause or the commerce clause is limited by the fifth amendment. *See Louisville Joint Stock Land Bank* v. *Radford*, 295 U.S. 555, 589–70 (1935), holding that the 1934 Frazier-Lemke Act was unconstitutional because its farm mortgage moratorium provisions did not protect mortgagees from erosion of their security by the accumulation of prior tax liens. Recognizing that the fifth amendment applied, in *Continental Illinois National Bank & Trust Co.* v. *Chicago R.I. & P. Ry.*, 294 U.S. 648 (1935), the Court held that postponement of creditor remedies pending a reorganization was not the equivalent of an unconstitutional taking, so long as the postponement did not impair the pledgees' liens or otherwise depreciate their security. Since the security was worth three times the amount of the pledgees' notes, the postponement of their recovery until a plan of reorganization was not a violation of the taking clause.[7]

[7] In January 1971 when issuance of the trustees certificates was authorized, the reorganization court made the findings which the fifth amendment taking clause requires. *In re Penn Central Transportation Co.*, 325 F. Supp. 302 (E.D. Pa. 1971). There is in *In re Prima Co.*, 88 F.2d 785 (7th Cir. 1937), extravagant language suggesting that because the bankruptcy power is vested in Congress by the constitution, under former

Third Avenue and *Jersey Central* represent efforts by reorganization courts to draw the line between mere postponement, permitted by *Continental Illinois National Bank & Trust Co.* v. *Chicago R.I. & P. Ry., supra,* and erosion of security which amounts to a taking and is forbidden by *Louisville Joint Stock Land Bank* v. *Radford, supra,* and the fourteenth amendment cases such as *Brooks-Scanlon.* They spell out the findings which must be made to insure that the reorganization court is not engaged in an intentional uncompensated taking.[8] In the *Selkirk Yard* and the *Mortgage Releases* cases we recognized that those findings were required in the Penn Central reorganization.

The government, and to a lesser extent the trustees, urge that the *Brooks-Scanlon-Louisville Joint Stock Land Bank-Third Avenue-Jersey Central* learning is obsolete because in the *Penn-Central Merger Cases* and *New Haven Inclusion Cases* the Court laid down a new principle of constitutional law. That new principle, they urge, is that secured investors in a railroad enterprise take on obligations in relation to the public which makes it appropriate that they run such risk of erosion of their investment as is necessary in the public interest in order to preserve railroad service. Neither appellee suggests the precise contours of what

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§ 77B and under § 77(c)(3), 11 U.S.C. § 205(c)(3), first lien certificates can be issued without regard to the taking clause. The *Prima* opinion writer, however, makes no mention of either *Continental Illinois National Bank & Trust Co.* v. *Chicago R.I. & P. Ry., supra,* or *Louisville Joint Stock Land Bank* v. *Radford, supra,* and on the facts no taking was involved. We do not regard the *Prima* discussion as authoritative.

[8] As our discussion of the New Haven reorganization, *infra,* suggests, the *Third Avenue* and *Jersey Central* rules provide no guarantee against creditor loss, but only against an intentional uncompensated taking.

is claimed to be the new constitutional rule. The government, however, points out that in the New Haven reorganization erosion of the interests of secured creditors amounted to $70 million while the railroad was waiting to be included in the Penn-Central merger. *See New Haven Inclusion Cases*, 399 U.S. at 490. We know, with the benefit of hindsight, that since 1968 the New Haven bondholders have fared even worse. If the results of the New Haven reorganization determine the constitutional limitations of a reorganization court's power to subject mortgaged assets to erosion, there may be no limitation whatsoever. We turn, then, to a consideration of the two cases on which appellees rely. To put them in context some understanding of the background of the New Haven reorganization is required.

When the New Haven petition was filed on July 7, 1961 the railroad had incurred, in a period of relatively high economic activity, net operating losses in 1958, 1959, 1960, 1961 and the first half of 1962. Since these losses had occurred in a period of prosperity it could not look forward to an economic turnaround which would, as in the earlier reorganization, begin to produce a net operating income with which to meet fixed charges. Section 77(b) provides:

> "A plan of reorganization within the meaning of this section . . . (4) shall provide for fixed charges (including fixed interest on funded debt, interest on unfunded debt, amortization of discount on funded debt, and rent for leased railroads) in such an amount that, after due consideration of the probable prospective earnings of the property in light of its earnings experience and all other relevant facts, there shall be adequate coverage of such fixed charges by the probable earnings available for the payment thereof; . . ."

There were no earnings, and no prospect of any, at any time during the New Haven reorganization. There was never, therefore, any prospect for a capitalized earnings reorganization. The alternatives were liquidation, nationalization, or merger. *See In re New York, N.H. & H.R.R.*, 289 F. Supp. 451, 456 (D. Conn. 1968). Nationalization was not forthcoming. Merger of a single New England system was explored. In March of 1962, when the Pennsylvania Railroad and the New York Central Railroad filed a merger application with the Interstate Commerce Commission the trustees intervened and asked to be included. Merger was anticipated as early as March 5, 1962. *See* In re New York, N.H. & H.R.R., Six Months Interim Report of the Trustees (March 5, 1962), 2 New Haven Proceedings 700–(1), 700–(30–31). By late 1963 it was clear that inclusion in the Penn-Central merger or liquidation were the only courses open to the reorganization court. *See In re New York, N.H. & H.R.R.*, 304 F. Supp. 793, 800 (D. Conn. 1969). The ICC, which under § 77(d) had responsibility for formulating and certifying a plan of reorganization, recommended inclusion rather than a dismissal of the proceedings which would have resulted in liquidation. Once that decision was made the questions facing the reorganization court were (1) how much were the New Haven assets worth, and (2) as of what date would they be valued. Judge Anderson throughout the proceedings made it clear that he was attempting to balance the considerations favoring postponement of creditors' remedies discussed in *Continental Illinois National Bank & Trust Co. v. Chicago R.I. & P. Ry., supra,* against those preventing intentional erosion discussed in *Third Avenue. See, e.g., In re New York, N.H. & H.R.R.*, 289 F. Supp. 451, 459 (D. Conn. 1968). What he attempted was a preservation for the creditors of

"fair liquidation value." This value was ascertained by determining what the creditors would have realized upon liquidation, taking into account that liquidation of an enterprise as large as the New Haven could not have been accomplished except over a long period. As Judge Anderson put it:

> "[T]he term 'fair liquidation value' has been used in the present case to describe a method or theory of determining value. It envisioned sales of New Haven property over a period of six years and of economic factors related to the business of turning the properties into cash." *In re New York, N.H. & H.R.R.*, 304 F. Supp. at 805.

The *New Haven* reorganization court, in other words, considered that it was applying, rather than rejecting the holding of *Brooks-Scanlon, Eastern Texas* and *Third Avenue. See, e.g.*, 304 F. Supp. at 804.

In the *Penn-Central Merger Cases*, 389 U.S. at 507–11, the Supreme Court considered a New Haven bondholder's objection to the terms of an ICC order, approved by the reorganization court, providing for inclusion of the New Haven in the Penn-Central merger at an asset value of $125,000,000, for interim loans from Penn Central to the New Haven trustees, and for Penn Central to bear certain New Haven operating losses. The bondholders contended that the interim arrangement did not sufficiently protect them because it did not require that Penn Central absorb all New Haven operating losses. The Court rejected the bondholders' appeal. It pointed out that "[t]he merits of these provisions [of the ICC order] are not before us." *Id.* at 509. It went on to say:

> "While we reject the appeals of the N H bondholders, acceptance or rejection of the terms and conditions on behalf of the N H remains to be determined. The bondholders'

> objections may be registered and adjudicated in the bankruptcy court or upon judicial review as provided by law." *Id.* at 511.

Penn-Central Merger Cases, supra, clearly cannot be construed as a rejection of *Brooks-Scanlon, Eastern Texas* or *Third Avenue.* On the contrary, it approved of an immediate interim consummation of a merger which was to accomplish an application of Judge Anderson's "fair liquidation value" approach. It left open the question whether the interim arrangement approved by the ICC adequately protected the bondholders from erosion, but it assumed that such protection was required.

Protracted valuation proceedings followed in two separate tribunals. These were reviewed in 1970 in the *New Haven Inclusion Cases, supra,* decided eight days after the filing of the petition which commenced the instant reorganization. Critical to an understanding of the *New Haven Inclusion Cases* are (1) the fact that the merger between New Haven and Penn Central had been consummated on February 1, 1968, and (2) the fact that the case only involves how much Penn Central, an unwilling purchaser, would be forced to pay as the "fair liquidation value" of assets which it acquired before the price was finally fixed. Since valuation litigation had proceeded simultaneously both in the reorganization court pursuant to § 77 of the Bankruptcy Act, and before a three-judge district court pursuant to § 5 of the Interstate Commerce Commission Act, the Supreme Court's first task was to determine which court had jurisdiction to make the determination. It decided that the three-judge court should have deferred to the reorganization court, 399 U.S. at 430, and that the reorganization court could properly review the valuation of the New Haven assets made by the ICC. Significantly, both the ICC

and the Supreme Court accepted the reorganization court's liquidation approach to valuation.

> "As the Commission described it, 'Liquidation value as used by both the N[ew] H[aven] trustees and Penn-Central [was] the estimated market value that would be realized in a total liquidation, less the cost of dismantling the property and other liquidation costs and after discounting proceeds to present worth.' 331 I.C.C., at 697." 399 U.S. at 436.
>
> "Consistent with the liquidation hypothesis, both New Haven and Penn Central deducted from the gross value of the New Haven assets the expenses that would be incurred if a liquidation in fact took place." *Id.* at 437.
>
> "The Commission concluded that once the New Haven estate embarked on a liquidation sale . . . 'the bulk of the liquidation could be completed within a period of 6 years.' 331 I.C.C., at 663." *Id.* at 437–38.

The lengthy discussion of valuation in the opinion of the Court in the *New Haven Inclusion Cases* is premised on the underlying assumption that the New Haven creditors were entitled to liquidation value, subject to a deduction for those expenses which would necessarly have been incurred during a liquidation. The Court wrote:

> "The purchase price that the Commission and the reorganization court have required Penn Central to pay to the New Haven estate is based upon the liquidation value of the seller's assets, appraised as of December 31, 1966. That price hypothesizes a shutdown of New Haven followed by a sell-off of its assets at their highest and best value. In the circumstances of this case, and for the reasons we have already set out at length, we agree with the reorganization court that it would be unfair and inequitable to allow Penn Central to take the properties for any

> lesser sum. Moreover, we today require a reassessment of the consideration that Penn Central is to give in exchange for those properties. *We thereby accord the bondholders the right to a liquidation and a per-parcel sale that is theirs by virtue of their mortgage liens.*" Id. at 489–90 (emphasis added).

The government and the trustees point to the disallowance by the Supreme Court of $70,000,000 in pre-1968 New Haven administrative expenses and of depreciation during the same period as costs to Penn Central. But the Supreme Court pointed out that until well after the 1966 valuation date the bondholders had acquiesced in continuing the proceedings rather than moving for liquidation. *Id.* at 493. The constitutionality of the erosion which had taken place prior to the valuation date was never presented to the court in any proceeding in which it could have passed upon that issue. The *New Haven Inclusion Cases* decide no more than that Penn Central does not have to pay for erosion which took place prior to its purchase of the assets.

With the benefit of hindsight it can be said that the New Haven bondholders have not fared as well as they would have had Judge Anderson dismissed the proceedings and commenced a liquidation in 1961. But judicial proceedings often produce less than perfect results even when settled legal principles are applied. The erosion which took place in the New Haven reorganization did not occur because either the reorganization court or the Supreme Court considered that a new interpretation of the fifth amendment was being announced. Rather the reorganization court acting slowly, but with the concurrence of the bondholders, sought a purchaser which would pay creditors what *Brooks-Scanlon, Eastern Texas* and *Third Avenue* required. The Supreme Court merely approved the re-

organization court's application of settled fifth amendment law. Nothing more was presented to it in either of the cases relied on by the government and the trustees. Neither the *Penn-Central Merger Cases* nor the *New Haven Inclusion Cases* cast doubt upon the continued viability of the *Third Avenue* and *Jersey Central* rules.

PENDING LEGISLATIVE PROPOSALS

The appellees suggest that we can take judicial notice of proposed legislative solutions for the northeast rail transportation crisis which at the time of argument were under active consideration in Congress and have since been enacted. They suggest, further, that such judicial notice can serve as a substitute for the findings required by the *Third Avenue* and *Jersey Central* rules. We do take judicial notice that legislative solutions were under active consideration, and have now been enacted.[9] We also take notice that it is

[9] The Regional Rail Reorganization Act of 1973, Pub. L. No. 93-236, 87 Stat. 985, enacted January 2, 1974, establishes the United States Railway Association whose duty is to prepare a final plan for acquiring and distributing some of the assets of each bankrupt northeast railroad permitted by its reorganization court to participate. If a reorganization court finds the Act does not provide a process which would be fair and equitable to the estate of the railroad, it may either attempt a separate reorganization under § 77 if it finds the railroad is reorganizable on an income basis, or dismiss the reorganization proceeding. Assuming that the Act withstands constitutional scrutiny, *see, e.g.*, N.Y. Times, Jan. 25, 1974, p. 43, cols. 5-7 (New Haven trustees' suit challenging the Act), and that the procedure contemplated is not interrupted, the transfer of assets would take place approximately 510 days after enactment. Loans and emergency grants are available, but there is no indemnification against interim losses. Section 303(c) of the Act contemplates that no more shall be paid in compensation than is "fair and

highly likely that some form of rail transportation system, publicly or privately owned, will almost certainly survive even if the present proceedings under § 77 are dismissed. But such judicial notice cannot serve to enlarge the power of the reorganization court and the ICC to subject the property of secured creditors to a taking while, like Mr. Micawber, they wait for something to turn up. Congress, in devising a legislative solution, will be bound by the fifth amendment to pay the fair value of the Penn Central properties at the time any new rail transportation entity takes them. Any amount beyond that value, which would compensate secured creditors for the erosion which took place while the reorganization court and the ICC waited for a congressional solution, would be a matter of legislative grace. It would be hazardous, indeed, to speculate on the likelihood of favorable exercise of such largess from public funds, especially in view of the form of the legislation recently enacted.[10] Moreover the *Third Avenue* and *Jersey Central* rules are predicated upon the feasibility of a reorganization under the present statutes; that is an earnings-based reorganization. *See* Bankruptcy Act, § 77(b), 11 U.S.C. § 205(b). If, as some of the reports filed by the trustees suggest, it is already clear that

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equitable", which is defined as the minimum constitutionally required. In determining whether to participate in the proceedings under the Act, the reorganization court will have to be cognizant of the limitations imposed by the fifth amendment. Unless adequate protection against interim losses can be obtained either in the form of emergency grants, loans under which the Association bears the risk and burden of loss at least ahead of secured creditors, or constitutionally compelled compensation under the final plan, it may be neccessary to dismiss the reorganization.

[10] *See* note 9 *supra.*

such a reorganization is not feasible,[11] then this reorganization is already at the point where the erosion of the estate in deficit operations must cease and a liquidation alternative must be considered if the secured creditors or other interested parties insist upon such consideration. Unlike the secured creditors in the earlier stages of the New Haven reorganization, appellants do insist that at least they be heard on the issue with respect to the orders appealed from.

If the marshaling rule is applied and the government's lien reduced to the extent that it has consented to expenditures of the proceeds of sale of unmortgaged capital assets in the manner provided in the orders appealed from, then the problem of an unconstitutional taking from the bondholders by virtue of those orders disappears. The Emergency Rail Services Act does not expressly forbid application of that rule to the government's lien. That Act provides that "proceeds from the sale of assets will be devoted *to the fullest extent possible* to the provision of essential transportation services by the railroad." 45 U.S.C. § 662(b)(3) (emphasis added). A reasonable construction of the statute is that "to the fullest extent possible" means to the extent permitted by the fifth amendment in striking the balance, under § 77, between secured creditors and the public.[12] That balance, at some point, prohibits further erosion of the mortgaged estate, and therefore requires application of the

[11] *See, e.g.*, Trustees' Interim Report of February 1, 1973; Memorandum accompanying July 2, 1973 Plan of Reorganization of the Penn Central Transportation Company and Other Railroad Corporations (June 29, 1973).

[12] When it originally approved sale of the trustees certificates in January 1971, the reorganization court observed that the § 662(b)(3) qualification "to the fullest extent possible" was a congressional recognition of this constitutional limitation. 325 F. Supp. at 306.

marshaling rule if the reorganization court finds that the government has consented to the expenditure of its unmortgaged security in the deficit operation of the railroad. Under this construction of the Emergency Rail Services Act of 1970 it is up to the government to determine, as the reorganization proceeds to what extent it consents to the erosion of its security, by virtue of the marshaling rule, while it waits for the realization of a legislative solution.[13] As to the proceeds already spent the district court has not yet determined whether the government consented to the expenditures. If it finds such a consent, the marshaling rule will apply. If it finds no such consent, it must determine in the first instance what other method of restoring the fund, if any, is feasible in the circumstances.

CONCLUSION

The orders appealed from will be reversed to the extent that they permit the expenditure of proceeds of sale of unmortgaged capital assets of the debtor for general operations of the debtor or for reimbursement of operating funds for past or future additions or betterments to unmortgaged assets. The orders will be remanded to the district court for further proceedings consistent with this opinion.

ROSENN, *Circuit Judge*, concurring.

I concur with the majority but I believe that two steps in the majority's analysis require further amplification.

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[13] Rights of unsecured creditors and stockholders in the unmortgaged assets are not before us on this appeal. Nor does the appeal present the issue whether erosion prohibited by *Louisville Joint Stock Land Bank* v. *Radford*, *supra*, is taking place solely by virtue of the accrual of unpaid administration expenses such as state taxes due to prolongation of the reorganization.

I understand the reasoning of the majority to be as follows. *Jersey Central* and *Third Avenue*, which restrict the use of proceeds received from the sale of mortgaged assets, survive the *New Haven Inclusion Cases*. Because of the prior Government lien in the form of Trustees' Certificates, *Jersey Central* and *Third Avenue* are applicable here even though the secured parties do not have a direct secured interest in the assets being sold. The findings which are required by *Jersey Central* and *Third Avenue* were not made, and apparently could not have been made, by the reorganization court. Since *Jersey Central* and *Third Avenue* define constitutional standards, marshaling is required in order to avoid an uncompensated taking of the secured parties' property whenever any proceeds are to be used for operating expenses or additions and betterments in the absence of the required findings. Furthermore, the Emergency Rail Services Act is consistent with the marshaling rule whenever that rule is constitutionally required.

I. APPLICABILITY OF JERSEY CENTRAL AND THIRD AVENUE

The Trustees argue that even if *Jersey Central* and *Third Avenue* are still good law, the two cases do not apply to the present situation because the assets sold were unmortgaged. The majority holds these cases nevertheless applicable on the theory that the sale of the unmortgaged assets without providing protection for the secured parties is the equivalent of the issuance of additional Trustees' Certificates.[1] "Looking to fact

[1] A numerical example might help to clarify this point. All asset values are in terms of what a sale would ultimately bring on liquidation.

Assume total assets of the debtor are worth 25 hypothetical units, the prior Government lien on all assets is in the amount of 15 units, and the secured parties have mortgages in the

rather than to form," the majority asserts that since findings would be a necessary prerequisite to the issuance of additional Trustees' Certificates, the same findings should be required here. The majority apparently concludes that *Jersey Central* or *Third Avenue* findings must be made before any property subject to the Government lien may be sold and the proceeds used for operating expenses or for additions and betterments.

This "fact" over "form" analysis, however, depends upon the possibility of an eventual "spillover" of the prior Government lien from the unsecured assets to the secured assets in the event that the unsecured assets prove insufficient to satisfy the lien on liquidation. A situation may arise in the future in which sufficient *unsecured* assets to satisfy the prior Government lien would clearly remain after a proposed sale of unsecured assets had taken place. In such a situation, the existence of the prior Government lien would have

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amount of 10 units on assets worth 10 units. Fifteen units of unmortgaged assets therefore remain. On liquidation, the Government will receive its 15 units from the unmortgaged assets, while the secured parties will receive their 10 units from the mortgaged assets.

If the debtor were to sell unmortgaged assets worth 5 units and dissipate the proceeds in operating losses, on liquidation the unmortgaged assets would be worth 10 units while the Government lien would still be in the amount of 15 units. If, instead, the debtor were to borrow 5 units from the Government in exchange for the issuance of additional Trustees' Certificates in the same amount, and the proceeds were dissipated in operating losses, on liquidation the unmortgaged assets would be worth 15 units while the Government lien would be in the amount of 20 units.

In either case, therefore, since the Government lien receives first priority even on the mortgaged property, the secured parties lose 5 units of their security to the Government and receive only the 5 units remaining after full satisfaction of the Government lien.

no effect upon the secured interests,[2] and I believe the proposed sale could then be treated exactly as would a proposed sale of unmortgaged property in the absence of the Government lien. The secured parties would have only an interest common to all general unsecured creditors in the sale of the unmortgaged asset in question, and would have no special right to require that *Jersey Central* or *Third Avenue* findings be made before the unmortgaged property could be sold. The reorganization court in the instant case, however, made no findings that the remaining unsecured assets were adequate to satisfy the prior Government lien and to protect the secured parties from injury resulting from possible future erosion of unsecured assets.

II. SCOPE OF JERSEY CENTRAL AND THIRD AVENUE

I do not believe that the foregoing analysis conclusively determines that *Jersey Central* or *Third Avenue* findings were required in this case, however, as to the use of proceeds from the sale of securities formerly a part of the Contingent Compensation Reserve Fund (Orders 1087 and 1088). The Trustees argue, in effect, that the securities making up the Fund do not constitute the kind of "asset" to which *Jersey Central* or *Third Avenue* apply: the Fund was simply a reserve which the company voluntarily set aside to met future ordinary expenses, namely, the payment of retirement benefits. As such, they contend, it was similar to a bank account.

[2] In the numerical example in note 1, *supra*, if the initial assets were worth at least 30 units, and if 5 units of cash were raised by either method and the proceeds dissipated in losses, then the secured parties will nevertheless receive their full 10 units from the mortgaged assets. Of course, because of the considerable uncertainties inherent in a reorganization procedure, the secured parties could be treated as having the interest of general creditors in the unmortgaged property only if the assets were initially worth considerably more than 30.

In fact, this court recently held, in an opinion by Judge Gibbons, that the Contingent Compensation Plan involved here was merely an executory contract calling for the payment of future retirement benefits, and the Fund was held as a part of the company's general assets subject to whatever use and disposition the company desired. *In Re Penn Central Transportation Company*, 484 F.2d 1300, 1305 (3d Cir. 1973), *petitions for cert. filed*, 42 U.S.L.W. 3379 (U.S. Dec. 21, 1973) (No. 73-964) and 42 U.S.L.W. 3406 (U.S. Jan. 2, 1974) (No. 73-1039).

It is not sufficient to say, as does the majority, that *Jersey Central* or *Third Avenue* findings are required merely because the Government lien concededly attaches to the Fund. If that were the only prerequisite to the requirement that findings be made, findings would be required before *any* property to which the Government lien attached could be used for operating expenses.

In permitting the issuance of the Trustees' Certificates initially, the reorganization court ordered that the Government lien attach to

> all the property, real, personal, and mixed, and the earnings and income thereof, now owned or hereafter acquired by the Trustees as such, said charge and direct first lien to be prior in right to . . . the liens of each and every mortgage created by [the Penn Central Transportation Company].

In Re Penn Central Transportation Company, E.D. Pa. No. 70-347 (January 13, 1971). This provision appears on its face to cover all assets whatsoever, including bank accounts.[3]

[3] The statutory requirement is that the Trustees' Certificates be "treated as an expense of administration and receive the highest lien on the railroad's property and priority in payment under the Bankruptcy Act." 45 U.S.C. § 662(c).

The majority, as well as the secured parties, would surely not go so far as to contend that just because the Government lien attaches to cash on hand and bank accounts, that such accounts could not be used for operating expenses. Such a holding would of course prevent payment of essential expenses such as wages, salaries, and necessary supplies, and require immediate liquidation of the debtor whenever *Jersey Central* or *Third Avenue* findings could not be made.

I raise this point only to point out that an additional distinction must be made between those "assets" transitory in nature which derive from operating revenues and are turned over daily, and those income producing assets in more durable form which tend to be held for long periods of time. Secured parties are not seriously injured by the daily turnover of unmortgaged assets in the first category, even though technically there is less unmortgaged property available to support the Government lien each time money is spent for operating expenses. Only when assets in the durable category are involved might the secured parties have a legitimate interest in preventing use of proceeds for operating expenses or for additions and betterments.[4]

[4] The point I make in this section is distinct from the point made in Part I. There, the question was whether the secured parties were to be treated as having an interest of secured or unsecured creditors in the unmortgaged property being sold, with findings required only in the former case. Here, the question is, even assuming the property in question is to be treated as mortgaged property (i.e., findings are generally required), whether findings are to be required for all expenditures whatsoever. If this is answered in the affirmative, a finding that the secured parties are to have the protection of *Jersey Central* and *Third Avenue* is equivalent to a prohibition on the spending of any money at all for operating expenses, and therefore a requirement of immediate liquidation.

The real estate properties involved in Orders 1073, 1103, and 1156 are clearly in the second category and thus require findings if, as, and when the reorganization court orders the use of the proceeds for operating expenses or for additions and betterments. I have more difficulty with the securities held in the Contingent Compensation Reserve Fund, however, since the Fund has many of the characteristics of ready cash retained for convenience in the form of securities. On balance, however, I agree with the majority that the securities in question were assets in the second category requiring findings. The Fund was clearly set aside as a reserve for certain specific expenses which would arise in the future, even though the company was not ultimately obliged to use the Fund for that purpose. I do not desire to penalize the company for its sagacity and vision in voluntarily maintaining such a Fund. It must be recognized, however, that in this case the company desires to use the Fund for a purpose which was far different than the one for which it was maintained and which would exhaust the Fund at a far earlier period in time. Moreover, these were not assets used in the day to day operation of the railroad. I believe that at least in this situation the Fund should not be treated as a simple bank account, and that *Third Avenue* findings are required.

A True Copy:

Teste:

Clerk of the United States Court of Appeals
for the Third Circuit.

APPENDIX B

United States Court of Appeals for the Third Circuit

Nos. 73-1260, 73-1271/73-1279, 73-1286/73-1287, 73-1299, 73-1414/73-1415

In the Matter of:

PENN CENTRAL TRANSPORTATION COMPANY, DEBTOR
GIRARD TRUST BANK AS INDENTURE TRUSTEE, APPELLANT IN NOS. 73-1260, 73-1274 AND 73-1276
BANKERS TRUST COMPANY, AS INDENTURE TRUSTEE, APPELLANT IN NOS. 73-1271, 73-1299 AND 73-1414
MANUFACTURERS HANOVER TRUST COMPANY and the FIDELITY BANK, AS INDENTURE TRUSTEES, APPELLANTS IN NOS. 73-1272, 73-1279 AND 73-1415
IRVING TRUST COMPANY, AS INDENTURE TRUSTEE, APPELLANT IN NOS. 73-1273, 73-1278 AND 73-1286
MORGAN GUARANTY TRUST COMPANY OF NEW YORK AS INDENTURE TRUSTEE, APPELLANT IN NOS. 73-1275, 73-1277 AND 73-1287

(D.C. No. 70-347 In Bankruptcy)

On Appeals From the United States District Court for the Eastern District of Pennsylvania

Present: MCLAUGHLIN, GIBBONS AND ROSENN, *Circuit Judges.*

JUDGMENT

This cause came on to be heard on the record from the United States District Court for the Eastern District of Pennsylvania and was argued by counsel.

On consideration whereof, it is now here ordered

and adjudged by this Court that order No. 1073, filed January 9, 1973, order No. 1103, filed February 9, 1973, orders Nos. 1087 and 1088, filed January 26, 1973 and order No. 1156, filed March 27, 1973, be, and the same are hereby reversed to the extent that they permit the expenditure of proceeds of sale of unmortgaged capital assets of the debtor for general operations of the debtor or for reimbursement of operating funds for past or future additions or betterments to unmortgaged assets, in accordance with the opinion of this Court. The cause will be remanded to the said District Court for further proceedings consistent with the opinion of this Court. Costs taxed against appellees.

Attest:

THOMAS F. QUINN,
Clerk.

February 6, 1974

APPENDIX C

Document No. 4954 (*Caption Omitted*)

MEMORANDUM AND ORDER No. 1073

(January 9, 1973)

FULLAM, J.

The Trustees have filed a petition (Document No. 4696) seeking leave to grant to Austin E. Knowlton Company a six-month option to purchase 4.339 acres of real estate in the City of Columbus, Franklin County, Ohio, for a total price of $825,000. As consideration for the option, the optionee would pay $10,000, to be credited on account of the purchase price if the option is exercised, otherwise to be retained by the Trustees.

At the hearing on the petition, there was no objection to the proposed transaction. The sole dispute concerns the disposition of the proceeds.

The property in question is not encumbered by any mortgages, but is subject to certain liens for real estate taxes, and to the general lien of trustees' certificates, guaranteed by the United States government. The Trustees propose to pay off the real estate tax liens, and to use the balance of the proceeds to reimburse the Debtor's general funds for certain additions and betterments made by the Trustees since bankruptcy for the benefit of other unencumbered assets of the Debtor.

The proposed payment of real estate taxes is not objected to by anyone. The United States government has not objected to the proposed sale or to the

Trustees' proposed use of the proceeds. However, certain indenture trustees, and the New Haven trustee (hereinafter collectively referred to as "respondents") contend that the proceeds should be deposited in escrow subject to the liens of the trustees' certificates.

In an earlier, virtually identical, transaction (Order No. 903, as amended by Order No. 917), this Court approved a sale of unmortgaged real estate and authorized the Trustees to retain the proceeds in the general fund of the Debtor. However, this was done without substantial objection from anyone. The issues now raised have not heretofore been squarely presented for decision.

It is conceded that the respondents have no present lien on the real estate, and could claim no present lien for themselves against the proceeds. Their objections to the Trustees' proposal fall into two categories: First, they contend that to approve the Trustees' petition would be to authorize the dissipation of a capital asset to support deficit operations, a kind of "cannibalization" that is impermissible in the absence of firm assurance of successful income-based reorganization of the railroad. Second, invoking principles of marshaling, the respondents argue that, if the Trustees' request is granted, there will be $800,000 less available to pay off the trustees' certificates (which prime respondents' liens on other property) than would be the case if the funds were to be held in escrow; if the funds are not escrowed, this Court should now declare that the ultimate enforceability of the government's lien with respect to mortgaged property is reduced by the amount of the proceeds.

In my view, a correct evaluation of the weight of these arguments must begin with recognition of the fact that, since bankruptcy, the Trustees have, with-

out objection and with the approval of this Court, made capital improvements to other unencumbered property of the Debtor, and have expended $2,867,188 of operating revenue for that purpose (affidavit of Paul R. Ness). Secured creditors, whether their liens are directly or only indirectly affected, have no right to insist that their lien values be increased through the expenditure of operating revenues. Thus, viewing all phases of these transactions as a unit, it is clear that the Trustees propose simply to convert an unproductive capital asset into other capital assets which make a significant contribution to the earning power of the Debtor's estate.

It follows from this analysis that neither of the arguments advanced by the respondents is acceptable. There is no dissipation of capital assets, no cannibalization. And the lien of the trustees' certificates is as applicable to the substituted assets as to the original asset.

In other contexts, the respondents have asserted that the cost of additions and betterments is not necessarily a proper measure of their value as security for liens. It may be that a similar contention is implicit in their present argument. Such an argument could conceivably involve several complex issues, such as the correct interpretation of, and the weight to be accorded to, relevant terms of various mortgage indentures; and whether liquidation value or "going concern" value would be the proper yardstick. But I do not believe it is necessary to explore these issues in depth in connection with the present application. If the proposed transaction is consummated, the Trustees will be crediting approximately $800,000 against additions and betterments which recently cost $2,867,188. It seems clear that, whatever valuation approach may

be adopted, these improvements have value greatly in excess of the amount of the proceeds here involved.

With regard to the respondents' second line of argument, that they are entitled to protection against the potential dilution of their security, several points should be made. In the first place, as noted above, there is no reduction in the quantity of unmortgaged capital assets available for the satisfaction of the trustees' certificates. Moreover, insofar as this real estate is concerned, the respondents have, at most, the status of general creditors. *See In re Chicago, Rock Island & Pacific Ry.*, 50 F. Supp. 835, 863 (N.D. Ill. 1943). Actually, the respondents would seem to be merely contingent general creditors, in the absence of proof that their own liens are inadequately secured. As the respondent's brief recognizes, their argument would be significant only if (a) the railroad is liquidated; (b) remaining unencumbered assets are insufficient to liquidate the trustees' certificates; and (c) the encumbered assets are insufficient to discharge the balance of the trustees' certificates, administration claims, and respondents' liens. There is no realistic basis for such morbid conjectures. It is the function, and intention, of this Court to make certain that the ultimate outcome of this reorganization, whatever form it may take, is consistent with the legal and constitutional rights of all parties involved. And, apart from any action which the Court might undertake on its own initiative, if the point is ever reached that there is a genuine threat of infringement upon the vested rights of the parties, I am confident that prompt and forthright legal steps would be taken by the parties threatened. In the absence of present justification for anticipating any such stark eventuality, the Trustees should not be deterred from implementing prudent business decisions.

The Trustees have an obligation to protect the interests of creditors. They also have an obligation to "make additions to take care of public needs or to lower operating costs." *RFC* v. *Denver, Rio Grande & Western RR.*, 328 U.S. 495, 515 (1946). The transactions here proposed are consistent with both of these objectives, and are in the best interests of all parties. The petition will be granted.

ORDER NO. 1073

AND NOW, this 9th day of January, 1973, upon consideration of the "Petition of the Trustees for Authority to Grant an Option to Purchase Real Estate in Columbus, Ohio," and upon hearing duly noticed, it is ORDERED:

1. The Trustees or their duly authorized designees are hereby authorized to grant an option on the property referred to for the consideration and on the terms set forth in the Petition, and if the option is exercised, the Trustees are authorized to convey to Austin E. Knowlton Company, or its nominee, at private sale and free and clear from all liens, the property referred to for the consideration and on the terms set forth in the Petition.

2. The Trustees or their duly authorized designees are authorized to execute and deliver any documents necessary to effectuate such transaction.

3. If the option is exercised, the net proceeds of such sale, after deduction of expenses of sale, shall be divided as follows:

> A. Upon approval of the necessary officers of the County of Franklin, State of Ohio, a sum equal to sixty percent (60%) of the principal amount of taxes that are unpaid and a lien on the property shall be paid to Franklin County, Ohio in complete discharge of all tax claims

or tax liens against the property, including any claim for interest and penalty; but if the approval of the necessary officers of the County of Franklin is not obtained, then an amount equal to the tax liens on the property shall be placed in escrow and all liens on the property conveyed pursuant to this Order shall attach to said funds, and any interest or income earned thereon, in the respective order of priorities thereof.

B. The balance of the net proceeds of such sale shall be kept in a special account and used by the Trustees to reimburse their general funds for additions and betterments previously or hereafter made on unmortgaged property owned by the Trustees.

C. The Trustees are directed (1) to keep separate records showing the amount in the fund, if any, the amount expended for additions and betterments on unmortgaged property, and the amount the Trustees have been reimbursed for expenditures or additions and betterments on unmortgaged property, and (2) to make such records available for inspection to parties in these proceedings upon such parties' request.

JOHN P. FULLAM,
District Judge.

538-890—74——5

Document No. 5014 (*Caption Omitted*)

MEMORANDUM AND ORDER No. 1087

Re: Retirement Programs—Contingent Compensation

(January 26, 1973)

FULLAM, J.

By virtue of various applications and responses thereto, all of which will be detailed later, the Court is required to make comprehensive rulings governing the status of various retirement programs and related programs of the Debtor. A brief description of the programs in question is set forth below; the actual application of each program to particular employees may vary depending upon hiring date and previous employment history:

1. *Retirement Programs.* The retirement programs detailed below are designed to complement and supplement employee benefits under the Railroad Retirement Act, 45 U.S.C. Sec. 228(a), and for the most part are applicable only to employees not covered by collective bargaining agreements.

(a) *Plan for Supplemental Pensions.* This plan is primarily funded with employee contributions. However, the Debtor makes certain annual contributions to insure the actuarial soundness of the plan. Order No. 278 in these proceedings recognizes that the Debtor had no interest in this fund, which, as of April 30, 1972, amounted to $353,521,624. The Debtor does, however, have the right to terminate the program, in which event the fund would be divided among the participants pro rata.

The only issue now before the Court is whether the plan should be terminated. The Debtor's contributions to the program amount to approximately $2 million per year. The trustees seek authorization to continue the program in operation.

(b) *Supplementary Benefit Arrangements.* In consequence of the merger between the New York Central and the Pennsylvania Railroad, the Debtor assumed the obligations of two non-contributory plans in effect at the time of the merger: the New York Central supplementary pension plan, and the New Haven pension plan. Under the terms of the respective plans, continuation of the program is optional with the Debtor (NYC pars. 11 and 12; NH par. 7). The Central plan applies only to those employees who were not entitled to participate in the contributory pension plan of that railroad and who had 20 years' service. The New Haven plan, applicable to "regular salaried supervisors and officials," was the only pension plan of the New Haven.

Forty-seven employees eligible under the Central plan receive a total of about $23,000 annually, approximately $480 per retiree. Three hundred forty-seven former New Haven employees receive a total of $285,000 per year, approximately $825 per retiree. These amounts are gradualiy diminishing as a result of attrition.

(c) *Interim or Early Retirement Plan.* This program is designed to facilitate the retirement of selected employees at age 60, rather than at age 65, by assuring total pension benefits equivalent to those which would have been received had retirement been postponed until age 65. Granting of such early retirement is discretionary with the company, but when early retirement has occurred, the company is legally obligated to continue the interim benefits. A similar program,

differing somewhat in its mechanics, was inherited from the New York Central in the merger.

For the year 1972, costs to the Debtor under the program amounted to $3,693,000. This cost would decline substantially in future years, unless additional employees are granted early retirement.

Implementation of the early retirement programs produces significant overall economies, making it possible to consolidate certain positions, or to replace highly paid employees with younger, less highly paid substitutes, without the disruptions which would ensue if employees with many years of long and faithful service to the railroad were to be discharged a few years short of retirement. The Trustees estimate that the net savings for the year 1972 amounted to $7.2 million. Projected savings to the year 1980 aggregate some $45 million.

(d) *Additional Pension Benefits.* The Debtor also provides certain additional pension benefits, in two categories: (1) Since 1961, the Debtor has had a policy of crediting prior executive experience with other employers toward the pension entitlements of newly hired executives over 35 years of age earning more than $20,000 annually. The difference between the pension computed with such credit and the pension which would have been paid without such credit is made up from the Debtor's estate. The additional costs under this constructive service policy aggregate approximately $87,000 annually at the present time, and could eventually amount to slightly more than $145,000 annually. The Debtor's constructive service policy follows the universal practice throughout the railroad industry.

(2) Benefits under the Plan for Supplemental Pensions are based upon the employee's average salary over the last five years of employment. Initially,

amounts allocated under the Contingent Compensation Plan (*see infra*) were included as salary, for purposes of this computation. However, a 1968 Internal Revenue Service ruling made it necessary to change this policy. Supplement A to the Contingent Compensation Program insures that persons retiring after 1968 will be treated the same as pre-1968 retirees; that is, the Debtor pays the difference between the actual pension benefits and what those benefits would have been if contingent compensation had been included in the computation.

The Trustees propose to continue to carry out all of the foregoing programs.

2. *Contingent Compensation Plan.* This is a complex program under which part of the salary of certain executives, instead of being paid currently in cash, was allotted to them for distribution after retirement. The amounts thus allotted were transferred to a Contingent Compensation Reserve Fund, for investment. This fund now amounts to slightly more than $10 million.

Shortly before the Debtor filed its reorganization petition, the Board of Directors suspended the Contingent Compensation Program, and it remains in suspension to the present date. The details of the program, and the Trustees' proposals with respect to it, will be discussed below.

I. LEGAL PRINCIPLES

Resolution of the conflicting contentions of the parties should begin with recognition of the following general principles:

1. Vested, fully funded contributory pension programs are not affected by the employer's filing for reorganization under Sec. 77. The assets in any such pension fund are not "property of the Debtor." This

much appears to be conceded by virtually all of the parties, and, in any event, has been resolved by Order No. 278 in these proceedings.

2. Irrespective of whether a pension plan is funded or refunded, continuation of pension payments thereunder is generally treated as a necessary and usual operating expense, payable by the Trustees during reorganization as a cost of doing business. Justification for this practice has been found to arise from the fact that the employee's past services helped to create and preserve the estate of the Debtor, *e.g., Bowen* v. *Hockley, et al.*, 71 F. 2d 781 (4th Cir. 1934), or from the necessity of preserving the loyalty and morale of present and future employees, *see: Tate* v. *New York, New Haven & Hartford R.R.*, 332 F. 2d 449 (2d Cir. 1964). However, insofar as current payments are concerned, the Trustees have the power to make adjustments in the amount and manner of payment, so long as this is done on an equitable and nondiscriminatory basis. *Tate* v. *New York, New Haven & Hartford R.R., supra.*

3. Contractual arrangements for deferred compensation, as distinguished from pension programs, may be disaffirmed by the Trustees, and the claims of employees or former employees resulting from such disaffirmance are not entitled to any special priority or acceleration; the claimants are merely general creditors of the Debtor's estate. *Alpert* v. *New York, New Haven & Hartford R.R.*, 348 F. 2d 304 (2d Cir. 1965).

There is thus no difficulty in concluding that the funded pension plan of the Debtor should continue undisturbed, and that the Trustees should continue to make the required contributions. Nor is there any reason for questioning the propriety of the Trustees continuing to carry out the various unfunded pension

programs outlined above. These are merely normal operating expenses.

The principal disputes in the present proceeding have to do with the correct treatment of the Debtor's Contingent Compensation Plan, and the legal propriety of imposing a maximum limitation upon the amount payable to any retiree. These issues will be discussed separately.

II. THE CONTINGENT COMPENSATION PLAN

There are two separate issues, or sets of issues, which must be decided in connection with the Contingent Compensation Program: (1) the status of the Contingent Compensation Fund ("Fund") which was established in connection with this program, and (2) the legal rights of participants in the program (the "Plan"). These issues are, of course, related, in the sense that both the Fund and the Plan must be considered in determining the basic question of whether this is a pension program or some other kind of arrangement; and it is therefore not surprising that the distinctions between the two sets of issues are sometimes obscured in the arguments of counsel. Nevertheless, the distinctions must be kept in mind.

Eligibility for participation in the Plan was limited to salaried employees and officers (except members of the Committee on Organization and Officers' Salaries) designated by the Board of Directors upon recommendation of the Committee. The stated purpose of the Plan was to attract and retain employees in "executive and other key positions." In practice, only persons earning more than $30,000 per year were eligible. A total of 164 employees participated in the Plan (on the date of bankruptcy, the Debtor had more than 92,000 employees, of whom 121 were participants in the Plan).

I agree with counsel for the objecting participants that the express terms of the Plan must be viewed in the light of the manner in which it was implemented. Generally speaking, whenever the union employees of the Debtor obtained wage increases through collective bargaining, non-agreement employees were given salary increases at approximately the same percentage of increase. And whenever such salary increases became effective, employees participating in the Contingent Compensation Plan received a part of the increase in cash, and the balance was allotted to them under the Plan. The precise apportionment between cash salary increase and allotment to the Plan was carried out on a sliding scale: for participating employees earning between $30,000 and $39,999 annually, 90% of each increase was paid in cash, and 10% went into the Contingent Compensation Plan. For each $10,000 of salary range, these percentages were shifted by 10%, so that, for employees earning $80,000 or more annually, only 20% of each salary increase was paid in cash, and 80% was allotted to the Plan.

Amounts allotted under the Contingent Compensation Plan were treated as operating expenses of the Debtor, but were not reported as compensation paid to the employees, nor were they then taxable as income to the employees.

The Plan provided that, unless otherwise specified by the Committee, allotments accumulated to the credit of a participant would be paid to him, if living, in 10 equal annual installments commencing after his attainment of age 65; or to his designated beneficiary or his estate, in a lump sum. In no case could payment of the full amount of the accumulated allotment be deferred longer than 10 years and 6 months after his death or, in the case of living participants, 10 years

and 6 months after attainment of age 65 or severance from employment, whichever was later.

Under the heading "General Description of the Plan," the Plan specifically states "it will normally provide such individuals with benefits after termination of service *by deferring compensation* until termination of service with the company . . . To achieve this purpose the plan provides *a method of compensating employees,* which differs in several respects from the customary cash payment. . . . [Emphasis supplied.] From this language, from the Plan as a whole, and from the manner in which the Plan was implemented, it is entirely clear that this was a plan for deferred compensation, and not a pension program. Unquestionably, participants in the Plan have valid and subsisting contractual claims against the Debtor's estate. While there are provisions in the Plan for forfeiture, no such forfeiture has ever been asserted in the past, nor does anyone now contend that the participants have forfeited their rights under the Plan. Indeed, the Plan provides, in Section 1401, ". . . no amendment, suspension, or termination [of the plan] may without his written consent, apply to the payment to any participant of any contingent allotment previously made to which he would otherwise be entitled."

The Contingent Compensation Reserve Fund which was established in connection with the Plan stands, however, on an entirely different footing. Section 401 of the Plan provides:

> "Section 401. The Board may authorize the establishment at any time of a contingent compensation reserve fund, hereinafter called the Fund. The Fund shall not be a trust fund and the assets therein shall be available at all times for any corporate purpose of the company. A

> participant shall have no right in or to any funds or property which may be held in the Fund."

And in Section 1201:

> "Section 1201. No participant nor any other person shall have any interest in any fund or in any specific asset or assets of the company by reason of amounts contingently allotted to him. . . ."

And, finally, in Section 1401:

> "Section 1401. . . . No consent of any participant shall be required, however, in connection with any amendment, suspension or termination of the contingent compensation reserve fund, which shall remain subject at all times to the unrestricted control of the company."

The Board of Directors did set up the Fund, as authorized, but not required, by the Plan. It is apparent that this step was taken in order to achieve two basic objectives: (1) to establish a reserve against the company's contingent liabilities under the Plan; and (2) to provide a mechanism for investing the reserve, and for enabling the participants to obtain the benefits resulting from such investment. Whenever a participant fulfilled all of the requirements of the Plan (*i.e.*, retired and was at least 65 years of age, or died) the total amount payable to him was determined by adding his accumulated allotments which had never been invested in the Fund, to the value represented by his proportionate share of the Fund. In theory, the participants were at risk; if the Fund's investments decreased in value, the participants' deferred compensation might be less than had been allotted to them over the years. As a practical matter, however, the Committee was in a position to terminate the Fund at any time, and presumably would

have done so if faced with any genuine prospect of erosion. Actually, the Fund increased in value over the years; but for the intervention of bankruptcy, the deferred compensation which would have been paid to the participants would in most cases have substantially exceeded the amounts originally allotted.

In view of the provisions of the Plan quoted above, the conclusion is inescapable that the participants have no claim whatever to the reserve Fund as such. The assets of the Fund were "property of the Debtor" on the date of bankruptcy, and are now vested in the Trustees. The objectors nevertheless argue that, in the hands of the Trustees, the assets of the Fund are impressed with a trust, or should be so treated on the basis of equitable considerations. In support of this argument, a number of factors are stressed.

(a) The assets of the Fund were always segregated (but the uninvested contingent allotments were commingled with the general assets of the Debtor for brief periods).

(b) From a balance sheet standpoint, the assets of the Fund, and uninvested contingent allotments, did not contribute to the Debtor's net worth (balancing debits and credits were shown). From this, the objectors contend that no creditor of the Debtor ever relied upon the Fund in extending credit. But this somewhat overstates the case. A creditor who examined the documents establishing the Plan and the Fund would have learned that the Fund assets were unencumbered assets of the Debtor. For present purposes, whether creditors made such inquiry and actually relied upon these assets in extending credit is not necessarily controlling.

(c) At no time, even in the cash crisis which immediately preceded bankruptcy, did the Debtor see fit to use the Fund for corporate purposes, or to borrow

against it. While this can be interpreted as showing that the Debtor's managers considered that these assets were held in trust, it may simply provide some insight into their sense of priorities. Moreover, the action of the Board of Directors, purportedly taken on June 20, 1970 (the day before bankruptcy) terminating all further contingent allotments, and directing that the participants' full salaries should thereafter be paid in cash, is persuasive evidence that all concerned understood the vulnerability of the arrangement in the event of bankruptcy.

The objectors further point out that many of the participants have made commitments, in such matters as estate planning and scale of living, in reliance upon anticipated receipt of contingent compensation pursuant to the Plan. This is undoubtedly a valid consideration. It establishes that the participants, like so many others, relied upon the financial soundness of the Debtor. It provides unnecessary further support for the proposition that the participants have valid claims against the Debtor's estate. But this factor must be balanced against countervailing equities in determining the extent to which these claims should be satisfied on a current basis during reorganization, rather than in the reorganization plan.

Originally, the Trustees sought authorization to terminate the Contingent Compensation Plan and disaffirm all obligations thereunder (Document No. 740), thus making the entire fund immediately available for general railroad purposes. Thereafter, recognizing the desirability of improving morale among the present employees, and after extensive negotiations, the Trustees modified their proposal. In their "revised petition . . . concerning Penn Central Transportation retirement programs" (Document No. 1793), the trustees requested leave to continue these programs in

effect; and in their "petition . . . for authority to settle claims under the contingent compensation plan" (Document No. 1794), the Trustees sought approval of an agreement embodying the following features: Of the approximately $8.6 million in the Fund as of December 31, 1970, the Trustees would remove approximately $6 million for general railroad purposes, and the balance of $2.6 million would be placed in a reserve fund managed by an independent financial advisor and distributed to the participants according to the terms of the Plan. The proposed allocation of the Fund is calculated to restore to the participants the amounts which they had actually been allotted and had not yet received, or their pro rata share of the Fund as of December 31, 1970, whichever was less (subject, in certain cases, to the $50,000 limitation hereinafter discussed). The participants would not benefit in the growth of the Fund since December 31, 1970. Of the 121 participants in the Plan as of June 21, 1970, 81 agreed to the Trustees' proposal, 33 objected, and 7 expressed no view.

For a variety of reasons, the Trustees' petitions were not immediately acted upon by this Court. The trustees' proposal has now, in effect, been withdrawn, and a further modification thereof substituted. In the meantime, the Fund has increased to approximately $10 million.

The Trustees' present proposal arises by reason of the prospect of a short-range cash emergency. The Trustees now propose to liquidate all of the assets in the Fund, and use the entire sum for current operating expenses, but to undertake, as an administrative obligation, to pay to participants, as cash permits, the same amounts contemplated by the earlier agreement. A further hearing to consider this proposal was held on January 10, 1973, but the line-up of objectors and

proponents remains substantially unchanged. Certain indenture trustees who endorse the legal position taken by the Trustees of the debtor vis-a-vis the participants, pressed further objections to the Trustees proposed use of the Fund.

Under the Trustees' proposal, the participants would relinquish all claims against the Debtor's estate and the Trustees, except their right to receive amounts equivalent to the unpaid balance of their contingent allotments (or their share of the Fund, valued as of December 31, 1970). I believe this over-simplifies the issue, and, arguably, cannot lawfully be imposed upon the participants without their consent. While it is true that the participants have no claim to the Fund itself, it is clear that the amounts of their claims under the Plan are to be measured by their pro rata share of the value of the assets in the Fund. The fact that the Committee could lawfully have refrained from investing any of the contingent allotments does not alter the plain language of the Plan, to the effect that fluctuations in the value of the Fund investments are to be reflected by equivalent changes (here, increases in most cases) in the participants' respective entitlements under the Plan. (Recognition of the validity of this analysis may be implict in the inclusion of a "most favored nation" clause in the Trustees' proposed agreement; this would purportedly assure settling participants further payments if the non-settling participants ultimately should fare better than the agreement contemplates.)

Thus, the narrow issue presented is whether, recognizing that all participants have valid lawful claims to the full amount provided for them under the Plan, it would be a proper exercise of discretion to permit present recognition and payment of a portion of each such claim during reorganization, while requiring such claimants to await the adoption of a plan of reorganization

before determining the correct treatment of the balance of their claims; and whether the basis on which the Trustees propose to grant such partial recognition is a fair and equitable one.

Since I am satisfied that, strictly speaking, the Trustees would have the right to defer the obligations created by the Contingent Compensation Plan in their entirety, leaving all participants to the proof of claims program, I am satisfied that the participants would have no just cause for complaint if a part of their claims should now be recognized and paid, so long as substantially equal treatment is afforded them. And since I am also persuaded that efficient operation of the railroad requires that employee morale be maintained at a high level, and that capable employees be encouraged to continue in the employ of the railroad, I am likewise satisfied that no creditor or other interest can validly object to the Trustees' proposal to assume the obligation of restoring to the participants the balance of their own 'contributions' under the Plan.

It is correct, as the opponents argue, that under the Trustees' proposal, present employees of the Debtor would receive proportionately larger payments during reorganization (*i.e.*, proportionate to the amounts of their total claims) than would retired participants. This is due to the fact that pre-reorganization payments to retired employees were measured by the full amount of each participant's entitlement; stated otherwise, the retired participants have already received payments which recognized the impact of increased values in the Fund. By the same token, however, the total dollars received by retired participants (in advance of the implementation of a plan of reorganization) will be greater than the amount received by present employees. This, of course, is as it should be, since the retired employees made 'contributions' over a

longer period, and in greater amounts, than the present employees.

On balance, I see no inequity in charging amounts which participants have already received from the Contingent Compensation Plan against the amounts which the Trustees will be required to pay in the course of the reorganization.

A further factor bears mention. It is apparent that the Contingent Compensation Plan was carefully drawn with a view toward possible tax consequences. As a general proposition, under the "constructive receipt" doctrine, to the extent that an employee had a non-forfeitable interest in the allotments, the allotments would have been includible in the employee's gross income in the year of the allotment. *See* Revenue Ruling 60–31, 1960–1 Cum. Bull. 174; Treasury Regulation 1.451–2; *Doty* v. *U.S.*, 323 F.2d 649 (6th Cir. 1963); E. T. *Sproull* v. *Commissioner*, 16 T.C.C. 244, *aff'd* 194 F.2d 541 (6th Cir. 1952). It is argued that the provisions of the Plan relating to the Debtor's right to use the Fund's assets for corporate purposes were not necessary to secure preferential tax treatment to the participants; but rather, these provisions were included to insure deductibility by the company of contingent compensation allotments at the time payments were made under the Plan. Assuming this to be true, one could hardly criticize management for such action: no inference of overreaching can be drawn. Moreover, nothing in the record negates the natural assumption that the corporate use provisions were included for the independent purpose of having the Fund's assets available should the need arise. I find unacceptable the suggestion that the clear language of the Plan documents should be brushed aside as unimportant because inserted in part for tax pur-

poses. To put the matter in a nutshell, in order to immunize the allotments from current taxation as income of the participants, and to insure deductibility by the employer, the parties set up a program which was vulnerable in bankruptcy. The Trustees' proposals represent a reasonable attempt to mitigate the adverse impact of bankruptcy, while preserving the tax consequences which were bargained for.

A further argument is made by some of the objectors that they were unaware of all of the ramifications of the Contingent Compensation Plan, believed that their 'contributions' were being held for them in trust, and would have sought employment elsewhere had they known of the true situation. The record does not support these assertions. While it is apparently correct that the participants did not see, and may not have had access to, the documents establishing the Plan, they were furnished, from time to time, summaries of these documents. These summaries appear in the record as follows: Exhibit C–1, dated December 29, 1952; C–2, dated May 20, 1955; C–3, dated January 20, 1956; C–4, dated September 25, 1963; C–5, dated February 1, 1968; and C–6, dated October 1, 1969. I have carefully reviewed all of these informational summaries and find that, while there are some variations in style and emphasis, all fairly and accurately portray the true nature of the Plan, in reasonably brief and non-technical language. In every case, the concluding section plainly states: "The assets of the contingent compensation reserve fund remain assets of the [railroad company] and subject to the rights of all creditors of the company . . . ." Moreover, there is actually no evidence in the record that any participant misunderstood the situation.

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III. THE $50,000 LIMITATION

By Order No. 12 in these proceedings, I directed that, until further order of Court, no payments be made from the estate of the Debtor to or on behalf of persons no longer employed by the Debtor on a full-time basis, at a rate in excess of $50,000 per annum. This Order remains in effect, and the Trustees propose to incorporate that limitation in the interim arrangements now under discussion.

As to six participants in the Contingent Compensation Plan (Messrs. Symes, Greenough, Saunders, Bevan, Perlman and Smucker), the effect of this limitation would be to reduce or eliminate their current participation in the Contingent Compensation Plan, by reason of the amounts being paid them currently under various aspects of the pension program. At the present time, by reason of Order No. 12, no retired employee is receiving more than $50,000 per year, in the aggregate, from the Debtor's retirement and contingent compensation programs. Counsel for all parties appear to be in agreement that participation in the fully funded plan (the Plan for Supplemental Pensions) cannot be thus limited. Mr. Symes is entitled to receive $52,776.12 per year from the funded plan, and Mr. Greenough is entitled to receive $68,478.68 per year from that program. Under the Trustees' proposal Mr. Greenough's contingent compensation would be the value of his units, $222,140.87, less contingent compensation paid, $200,000, or $22,-214.08, divided by the appropriate number of payments remaining to be paid under the Plan. The $50,000 limitation would preclude payment of that amount. Mr. Symes is entitled to no contingent compensation under the Trustees' proposal, since he has already received far more than either his original allotments or the value of his units on December 31,

1970. A special $10,000 per year benefit granted Mr. Symes by the Board after his retirement would also be precluded by the $50,000 limitation. Similarly, Mr. Smucker would not receive $5,515 from the unfunded programs that he would otherwise be entitled to, nor would he receive his contingent compensation payment computed at the valuation date of $11,154.15 per annum.

In the case of Mr. Perlman, his entitlement under the funded plan is $41,709.84 per year, which is being paid him. But for the $50,000 limitation, he would be entitled, under the Trustees' proposal, to receive $23,297.22 per year from the Contingent Compensation Plan. Application of the $50,000 limitation would reduce his participation in the Contingent Compensation Plan to approximately $8,200 annually.[1]

In the case of Mr. Bevan, his entitlement under the funded plan is $27,437.27 annually, and under other retirement programs an additional $50,194.24 annually. By reason of the application of the $50,000 limitation, his participation in the unfunded pension programs would be reduced, and his participation under the Contingent Compensation Plan would be eliminated (*i.e.*, insofar as current payments are concerned).

In the case of Mr. Saunders, he is entitled to receive annually $12,247.72 from the funded plan and $78,344.16 from other retirement programs. Application of the $50,000 limitation reduces Mr. Saunders' payments from the unfunded programs and eliminates current participation in the Contingent Compensation Plan.

[1] Shortly before reorganization, the Board of Directors entered into a further contract with Mr. Perlman, under which he would have performed services as a consultant, at a salary of $50,000 per year. This contract was disaffirmed by the Trustees before it became effective. Issues arising out of this disaffirmance are not before the Court at this time.

His entitlement under the Trustees' settlement formula would otherwise be $41,200 annually.

In the aggregate, application of the $50,000 limitation would reduce the amount payable on a current basis, under the contingent compensation plan proposal of the Trustees, by approximately $102,000 annually, and would reduce payments from the Debtor's estate under the unfunded retirement programs and otherwise in the amount of about $78,000 for the current year (this latter amount would fluctuate from year to year).

To the extent that the Trustees are required, or find it advisable, to establish a reserve to meet the obligations they propose to assume under the Contingent Compensation Plan, application of the $50,000 limitation would reduce the amount of the required reserve by approximately $1 million.

I have carefully considered all of the arguments advanced on all sides of this question, and have concluded that the $50,000 limitation originally imposed should remain in effect, insofar as that limitation can be achieved through payments within the control of the Trustees. That is to say, while neither the Trustees nor this Court can lawfully interfere with entitlements under the Plan for Supplemental Pensions (the fully funded plan), no payments should be made from the Debtor's estate during reorganization which would, as to any retiree, result in a total post-retirement income from all sources related to the Debtor (*i.e.*, the funded plan, the unfunded retirement programs, and the Contingent Compensation Plan) in excess of $50,000 per year.

In my view, it would be unconscionable to permit the payment in full of all retirement and deferred compensation, no matter how generous the amount, while the Debtor is unable to pay current taxes, or, for

example, to pay pre-bankruptcy personal injury claims for which it is legally liable. Conversely, elimination of all pension and deferred compensation payments from the Debtor's estate would be unduly harsh and, as noted above, would be likely to interfere with the smooth functioning of the railroad. The only acceptable solution is to impose a limitation of some kind.

It has been suggested that the only fair way to impose such a limitation would be on a percentage basis. I reject this approach, believing it would probably involve greater inequities than the flat limitation proposed. Moreover, a percentage reduction might make it difficult for retirees at the lower end of the scale to maintain themselves comfortably, and would permit payments to retirees at the higher end of the scale at unreasonably generous levels. While it is true that the flat $50,000 limitation has a greater dollar impact upon some retirees than others, it assures all retirees of a reasonably comfortable standard of living; moreover, for the most part, the retirees at the higher end of the scale achieved that position as the result of pre-bankruptcy salary policies which are most clearly vulnerable to criticism. On balance, I believe the $50,000 limitation represents an acceptable resolution of these competing considerations.

IV. IMPLEMENTATION

The Trustees originally proposed to set aside $2.6 million of the assets of the Contingent Compensation Reserve Fund in a separate fund, as a reserve against the payments which they are willing to assume under the Plan. They now propose to eliminate this reserve, and to make payments under the Plan "as cash permits." For the reasons previously discussed, it is clear that the entire Fund may be utilized, free and clear of

claims of the participants. The question remains, however, whether it would be desirable for the Trustees to expend the entire Fund to meet other current operating expenses, without regard to the obligations which the Trustees propose to assume.

It may well be that, if it should become necessary to choose between using the entire Fund or shutting down the railroad, the former would be the appropriate choice. But until such a choice becomes absolutely necessary, on the basis of actual rather than projected figures, I believe the $2.6 million should be held intact, as a reserve to meet the obligations assumed by the Trustees.

The Trustees' settlement proposal would have required participants to release all further claims arising under the Plan in order to receive current payments computed on the basis of (a) their total allotments, or (b) their share of the value represented by the Fund as of December 31, 1970, whichever was less; all payments previously received to be credited on account. They would thus have forever lost any right to claim a share in the incremental values in the Fund. On the other hand, they would have received payment during reorganization, and would have shared in any increase in the $2.6 million set aside for their benefit.

The arrangement approved herein embodies the following features: (1) the same formula for determining current payments is retained; (2) the validity of the participants' claims for the full amounts due under the Plan, calculated as of December 31, 1970, is preserved; (3) questions as to the participants' rights to share in the growth of the Fund from December 31, 1970 to the present date remain open for future determination; (4) $2.6 million of the Fund will not be used for operating expenses unless so ordered by this Court in the case of absolute necessity; (5) to the

extent that the $2.6 million reserve now being established may grow through investment, and is not used for operating expenses, the Trustees may at some future time be authorized to permit the participants to share in such growth.

I do not now decide that the participants could not lawfully be required to give up all further claims in exchange for current partial payment, but merely that there is room for doubt on the subject, and that the arrangements outlined above seem preferable.

Certain indenture trustees take the position that, while the entire Fund belongs to the Debtor's estate, free of any claims of the participants, it is subject to the lien of the trustees' certificates guaranteed by the federal government, and cannot be used to meet operating expenses except on the strength of a present decision by this Court that the lien of the trustees' certificates, as to encumbered assets of the Debtor, is reduced by that amount. I do not believe that issue is ripe for decision at this time. The government does not object to the Trustees' proposal, and I am satisfied that the use of unencumbered assets to meet operating expenses is entirely consistent with the Emergency Rail Services Act of 1970 (45 U.S.C. Sections 661–69) and the terms of the government's guarantee. For this Court now to attempt to forecast all of the possible legal consequences would serve no useful purpose.

V. CONCLUSIONS

1. The fully funded Plan for Supplemental Pensions should remain in full force and effect, unimpaired by the Debtor's bankruptcy. The Trustees should be authorized to continue to make contributions thereto, as a cost of doing business.

2. Subject to the limitations hereinafter mentioned, the Trustees should continue to make payments re-

quired by the various unfunded pension programs, as a cost of doing business.

3. Participants in the Contingent Compensation Plan have no legal or equitable interest in or claim to the assets in the Contingent Compensation Reserve Fund. Each participant in the Contingent Compensation Plan has a valid claim for the full amount to which he is entitled under the terms of the Plan, but the Trustees should be authorized and directed to recognize such claims during reorganization only to the extent represented by the formula proposed by the Trustees in settlement (*i.e.*, reimbursement of accrued allotments, or pro rata share of the Fund as of December 31, 1970, whichever was less); and such claims should be paid during reorganization only as cash permits. Unless and until otherwise ordered by this Court, the Trustees should set aside and reserve the sum of $2.6 million in order to meet these payments.

4. During reorganization, the Trustees should make no payments from the estate of the Debtor (whether by reason of unfunded retirement programs, or the Contingent Compensation Plan) where the effect of such payment would be that the aggregate amount received by a retired employee from all sources related to the Debtor (*i.e.*, the Plan for Supplemental Pensions, unfunded retirement programs, and the Contingent Compensation Plan) would exceed $50,000 per annum.

Appropriate orders will be entered in conformity with the views expressed herein.

ORDER NO. 1087—AUTHORIZING THE TRUSTEES TO CARRY OUT THE PROVISIONS OF CERTAIN PENSION PROGRAMS, AND TO MAKE CERTAIN PAYMENTS ON ACCOUNT OF OBLIGATIONS ARISING UNDER THE CONTINGENT COMPENSATION PLAN

AND NOW, this 26th day of January, 1973, upon consideration of the various Petitions of the Trustees relating to the retirement and contingent compensation programs of the Debtor (Documents Nos. 740, 1226, 1793 and 1794), and after hearings thereon duly noticed, it is ORDERED:

1. The Trustees are authorized to continue in effect the plan for Supplemental Pensions, in conformity with Order No. 278, and to make all payments required to implement the same.

2. Subject to the limitation set forth in paragraph 5 of this Order, the Trustees are authorized to continue in effect all of the existing pension programs and policies of the Debtor, and to make all payments required to implement the same.

3. Subject to the limitation set forth in paragraph 5 of this Order, from time to time during reorganization, as cash permits, the Trustees are authorized to pay to eligible participants in the (former) Contingent Compensation Plan of the Debtor amounts determined—in each case by the following formula, viz, (a) the lesser of (i) the total allocations to such participant, or (iii) an amount equal to the value of such participant"s share of the Contingent Compensation Reserve Fund as of December 31, 1970, less (b) the aggregate amount of payments heretofore made to such participant or account of his participation. All payments to participants during reorganization shall be made on a pro rata basis in relation to the amounts thus determined. Except as herein provided, disposition of all further claims on behalf of participants in the (former) Contingent Compensation Plan of the Debtor is deferred pending adoption of a reorganization plan.

4. It is adjudged and declared that the assets in the Contingent Compensation Fund are the property of

the trustees, free and clear of all claims, legal or equitable, of the participants or former participants in the Contingent Compensation Plan.

5. In no event shall the Trustees make any payment to or on behalf of any former officer or employee of the Debtor where the effect of such payment would be the receipt by such former officer or employee, from the Plan for Supplemental Pensions, all other unfunded retirement programs of the Debtor, and the Contingent Compensation Plan, in the aggregate, of more than $50,000 per annum.

JOHN P. FULLAM,

J.

Document No. 5015 (*Caption Omitted*)

ORDER NO. 1088—AUTHORIZING THE TRUSTEES TO WITHDRAW $7,400,000 FROM THE CONTINGENT COMPENSATION RESERVE FUND

AND NOW, this 26th day of January, 1973, upon consideration of the Petition of the Trustees for authority to Withdraw $7,400,000 from the Contingent Compensation Reserve Fund (Document No. 4886), and upon hearing duly noticed, it is ORDERED:

1. Subject to the limitation set forth in paragraph 3 of this Order, the Trustees and Kuhn, Loeb & Co. (as investment manager and custodian of the Contingent Compensation Reserve Fund ("Fund")), are authorized and directed forthwith to liquidate securities or other assets in the Fund (with the exception of the bonds of the Pittsburgh, Cincinnati, Chicago & St. Louis Railroad Company and the 7,500 shares of Madison Square Garden Corporation common stock), free and clear of all liens and encumbrances, and to deposit the proceeds for the Trustees' account in a bank to be designated by the Trustees.

2. Subject to the limitation set forth in paragraph 3 of this Order, the Trustees are authorized, upon the deposit of said proceeds, to make forthwith withdrawals therefrom to meet current operating expenses.

3. The Trustees shall, until further Order of this Court, reserve and set aside, from the assets of said Fund, or the cash proceeds derived from liquidation thereof, or a combination thereof, assets having an aggregate value of $2,600,000 as a reserve against liabilities which the Trustees may be authorized to pay during reorganization to participants in the (former) Contingent Compensation Plan. The Trustees are authorized to retain appropriate investments in the Fund, or to invest and reinvest said reserve of $2,600,000, in their discretion. Said reserve shall remain the property of the Trustees; establishment and maintenance of said reserve shall not give rise to any legal or equitable interest or claim therein on behalf of any participant.

4. The authority herein granted may be exercised forthwith, irrespective of the pendency of any appeal from this Order or from Order No. 1087 in these proceedings. No stay of this Order will be granted. In the event of a final judicial determination that the authority herein granted should not have been granted, the Trustees' obligation to restore amounts expended pursuant to this Order shall constitute an expense of administration.

JOHN P. FULLAM,
J.

Document No. 5127 (*Caption Omitted*)

ORDER NO. 1103

AND NOW, this 9th day of February, 1973, upon consideration of the PETITION OF TRUSTEES FOR AUTHORITY TO SELL A SECOND MORTGAGE NOTE SECURED BY REAL ESTATE LO-

CATED AT 1801 JOHN F. KENNEDY BOULEVARD, PHILADELPHIA, PENNSYLVANIA (Petition) and after a duly noticed hearing thereon, it is hereby ORDERED that:

1. The Trustees are authorized to sell the second mortgage note referred to in the Petition, free and clear of all liens and encumbrances, on the terms and conditions described in the Petition;

2. The net proceeds of such sale, upon receipt by the Trustees, shall be deposited in a general cash account of the Trustees and devoted to the fullest extent possible to the payment of expenses, which if not met would preclude the continued provision of essential transportation services;

3. The Trustees are authorized to execute and deliver or cause to be executed and delivered any documents necessary to effectuate the sale of the second mortgage note and to take any further steps that may be necessary and proper to accomplish the foregoing.

/s/ JOHN P. FULLAM,
District Judge.

Document No. 5423 (*Caption Omitted*)

ORDER NO. 1156—AUTHORIZING THE TRUSTEES TO SELL PROPERTY IN TOLEDO, OHIO TO VINYLAST CORPORATION

AND NOW, this 26th day of March, 1973, upon consideration of the PETITION OF TRUSTEES FOR AUTHORITY TO SELL REAL ESTATE IN TOLEDO, OHIO, TO VINYLAST CORPORATION, and upon hearing duly noticed, it is ORDERED:

1. The Trustees or their duly authorized designees are hereby authorized to sell to Vinylast Corporation, at private sale, free and clear from all liens, the property referred to for the consideration and on the terms set forth in the Petition, and to execute and deliver

or cause to be executed and delivered any documents necessary to effectuate such transaction.

2. The net proceeds of such sale, after deduction of expenses of sale, shall be divided as follows:

A. Upon approval of the necessary officers of the County of Lucas, State of Ohio, a sum equal to sixty percent (60%) of the principal amount of taxes that are unpaid and a lien on the property shall be paid to Lucas County, Ohio, in complete discharge of all tax claims or tax liens against the property, including any claim for interest and penalty; but if the approval of the necessary officers of the County of Lucas is not obtained, then an amount equal to the tax lien on the property shall be placed in escrow and all liens on the property conveyed pursuant to this Order shall attach to said funds, and any interest or income earned thereon, in the respective order of priorities thereof.

B. The balance of the net proceeds of such sale shall be kept in a special account and used by the Trustees to reimburse their general funds for additions and betterments previously or hereafter made on unmortgaged property owned by the Trustees.

C. The Trustees are directed (1) to keep separate records showing the amount in the fund, if any, the amount expended for additions and betterments on unmortgaged property, and the amount the Trustees have been reimbursed for expenditures for additions and betterments on unmortgaged property; and (2) to make such records available for inspection to parties in these proceedings upon their request.

3. The Trustees shall give to all parties at least ten (10) days written notice prior to their withdrawal of the proceeds, or any part thereof, referred to in paragraph 2B above.

/s/JOHN P. FULLAM,
District Judge.

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October Term, 1973

No. 73-1672

UNITED STATES OF AMERICA,

Petitioner,

v.

BANKERS TRUST COMPANY, GIRARD TRUST BANK, IRVING TRUST COMPANY, MANUFACTURERS HANOVER TRUST COMPANY, THE FIDELITY BANK, AMERICAN NATIONAL BANK AND TRUST COMPANY OF CHICAGO, MANUFACTURERS NATIONAL BANK OF DETROIT, NATIONAL COMMERCIAL BANK AND TRUST COMPANY, PEOPLES TRUST OF NEW JERSEY, THE BANK OF NEW JERSEY, THE BANK OF NEW YORK, THE CITY NATIONAL BANK OF CONNECTICUT and WILMINGTON TRUST COMPANY, as Indenture Trustees; and GEORGE P. BAKER, ROBERT W. BLANCHETTE and RICHARD C. BOND, as Trustees of Penn Central Transportation Company, Debtor,

Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Third Circuit

JOINT BRIEF OF RESPONDENT INDENTURE TRUSTEES IN OPPOSITION

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Dated: July 8, 1974

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IN THE

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UNITED STATES OF AMERICA,

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BANKERS TRUST COMPANY, GIRARD TRUST BANK, IRVING TRUST COMPANY, MANUFACTURERS HANOVER TRUST COMPANY, THE FIDELITY BANK, AMERICAN NATIONAL BANK AND TRUST COMPANY OF CHICAGO, MANUFACTURERS NATIONAL BANK OF DETROIT, NATIONAL COMMERCIAL BANK AND TRUST COMPANY, PEOPLES TRUST OF NEW JERSEY, THE BANK OF NEW JERSEY, THE BANK OF NEW YORK, THE CITY NATIONAL BANK OF CONNECTICUT and WILMINGTON TRUST COMPANY, as Indenture Trustees; and GEORGE P. BAKER, ROBERT W. BLANCHETTE and RICHARD C. BOND, as Trustees of Penn Central Transportation Company, Debtor,

Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Third Circuit

JOINT BRIEF OF RESPONDENT INDENTURE TRUSTEES IN OPPOSITION

Respondents Bankers Trust Company, Girard Trust Bank, Irving Trust Company, Manufacturers Hanover Trust Company, The Fidelity Bank, American National Bank and Trust Company of Chicago,* Manufacturers National Bank of Detroit,* National Commercial Bank and Trust Company,* Peoples Trust of New Jersey,* The Bank of New Jersey,* The Bank of New York,* The City National Bank of Connecticut* and Wilmington Trust Company,* as

* Prior to the filing of the Petition, American National Bank and Trust Company of Chicago, Manufacturers National Bank of Detroit, National Commercial Bank and Trust Company, Peoples Trust of New Jersey, The Bank of New Jersey, The Bank of New York, The City National Bank of Connecticut and Wilmington Trust Company succeeded to the indenture trusteeships formerly held by Morgan Guaranty Trust Company of New York.

Indenture Trustees (the "Indenture Trustees"), respectfully submit this Joint Brief in Opposition to the Petition for a Writ of Certiorari to review the judgment of the United States Court of Appeals for the Third Circuit in this matter. The opinion of the Court of Appeals is reported at 494 F. 2d 270 and is set forth as Appendix A to the Petition (App. 1a-37a).[1]

Question Presented

The sole question raised by the Petition is whether the Emergency Rail Services Act of 1970, 45 U.S.C. 661 *et seq.*,[2] exempts the United States, as the holder of a first lien on all the property of Penn Central Transportation Company, from the time-honored principles of equity governing the duties which a senior lienholder owes junior lienholders.

Statement

Between November 1972 and February 1973, the Trustees of Penn Central Transportation Company (the "Debtor") sought approval from the Reorganization Court of the sale of four capital assets and the use of the proceeds either to meet the general operating expenses of the railroad or otherwise to invest in the railroad. None of the four properties was subject to liens held by the Indenture Trustees, but each was subject to the lien of the United States arising from its guarantee, pursuant to the Emergency Rail Services Act of 1970, 45 U.S.C. 661, *et seq.*, of

1. References to (App.) are to the page numbers of the several appendices to the Petition herein.

2. Relevant provisions of this statute are quoted at pages 2-3 of the Petition.

an issue of $100 million in trustees' certificates. The United States' lien covers all the Debtor's property and is superior in priority to the liens of the Indenture Trustees.

In what has come to be known as the *Jersey Central* doctrine, after the decision in *Central R.R. Co. of New Jersey* v. *Manufacturers Hanover Trust Company*, 421 F. 2d 604 (3d Cir.), *cert. denied sub nom., Farrell* v. *Manufacturers Hanover Trust Company*, 398 U.S. 949 (1970), the Courts of Appeals for the Second and Third Circuits have over the years developed standards governing the circumstances under which capital assets of a debtor in reorganization could be sold and the proceeds used to meet its general expenses or otherwise invested without violating the constitutional rights of creditors secured by liens on those assets.[3]

In seeking the approval of the Reorganization Court of their proposed use of the proceeds from the sales of the four capital assets, the Debtor's Trustees did not allege, nor could they have proven, facts sufficient to meet the *Jersey Central* standards. Consequently a creditor, secured by a lien on those properties, had a constitutional right to prevent the sale proceeds from being used to cover the deficit operations of the railroad or otherwise invested in the railroad.

The Indenture Trustees objected to each of the four proposals. Invoking the equitable doctrine of marshaling, they urged that if the United States, with its lien on those properties, was unwilling to exercise its *Jersey Central*

3. The *Jersey Central* doctrine is discussed in detail in the Third Circuit's opinion. 494 F. 2d 275-276, App. 11a-14a.

rights to protect the security for its guarantee of the trustees' certificates, then the Reorganization Court should reduce the United States' lien in an amount equal to the value of the property lost thereby.

The Indenture Trustees' position was rejected by the Reorganization Court, but adopted by the Court of Appeals which reversed and remanded these matters to the Reorganization Court to determine whether the United States had or had not in fact consented to the Debtor's Trustees' proposed use of the proceeds.

Reasons for Denying the Writ

Jersey Central is sound and was correctly applied by the Court of Appeals.

Significantly the United States does not challenge the soundness of *Jersey Central, supra.* Decided in 1970, that case summarizes earlier decisions relating to the constitutional rights which secured creditors have to protect property subject to their liens from loss through unwise investment in a failing enterprise or in meeting the expenses of its deficit operations. Since 1970, the doctrine embodied in *Jersey Central* has been uniformly and consistently applied to a wide variety of situations.[4]

4. See, *e.g.*, the following decisions of the United States Court of Appeals for the Third Circuit, which as the appellate court with jurisdiction over the reorganizations of the Lehigh Valley Railroad, Penn Central Transportation Company and Reading Company has had to develop a familiarity with and expertise in Section 77 proceedings. *In re Penn Central Transportation Co.* (*Mortgage Releases*), 468 F. 2d 1222 (1972); *In re Penn Central Transportation Co.* (*Selkirk Yard*), 474 F. 2d 832 (1973); *In re Penn Central Transportation Co.* (*Park Avenue Properties*), 484 F. 2d 323, *cert. denied sub nom., Signer* v. *Trustees of Penn Central Transportation Co.*, 414 U.S. 1079 (1973).

Instead the United States urges rather vaguely that the Court of Appeals' decision below "extended" the *Jersey Central* principles and as such "limits the flexibility available to a reorganization court" and "effectively alters the structure of Section 77."[5] Even a cursory reading of the Court of Appeals' opinion below indicates that such is not the case. It is difficult to imagine how else the Court of Appeals could have decided this case without completely overruling the principles embodied in its earlier *Jersey Central* decision.

The difficulty which the United States has with the Court of Appeals' decision stems not from any consideration which, under this Court's Rule 19(1)(b) might justify grant of the writ, but from the fact that the decision prevents the United States from continuing its essentially schizophrenic role in the Debtor's reorganization proceedings. There the United States has part of the time been performing a governmental role in attempting to insure that the transportation services provided by the Debtor are maintained for the benefit of the public, and has at other times been performing as a creditor in attempting to insure that its guarantee of $100 million in trustees' certificates is at all times covered by adequate security. With respect to its willingness to allow the proceeds from the sale of these four capital assets to be used to continue the operations of the Debtor, the United States had clearly suppressed its creditor interests to further its other interests.

It is, however, precisely this sort of creditor schizophrenia that led to the development of the doctrine of marshaling. A court of equity will not allow a senior lienholder, who for reasons of his own fails to exercise his rights to security, to jeopardize thereby the rights of junior lienholders to that security.

5. Petition, pp. 10, 12, 14.

The Emergency Rail Services Act does not preclude application of marshaling to the United States.

The United States also argues that the Court of Appeals' decision "has in effect invalidated" and "effectively frustrates" Section 3(b)(3) of the Emergency Rail Services Act of 1970, 45 U.S.C. 662(b)(3). In rejecting that argument below the Court of Appeals held (494 F. 2d at 283, App. 28a):

> "The Emergency Rail Services Act does not expressly forbid application of that [the marshaling] rule to the government's lien. That Act provides that 'proceeds from the sale of assets will be devoted *to the fullest extent possible* to the provision of essential transportation services by the railroad.' 45 U.S.C. §662(b)(3) (emphasis added). A reasonable construction of the statute is that 'to the fuliest extent possible' means to the extent permitted by the fifth amendment in striking the balance, under §77, between secured creditors and the public." (Footnote omitted.)

The holding of the Court of Appeals is, we submit, correct.

In addition the United States argues that that holding is "in direct contravention" of Section 3(c) of the Act on the theory that that section creates an absolute lien. However, in granting the "highest" priority to the lien of the United States, Section 3(c) nowhere suggests that that priority will be maintained regardless of the subsequent behavior of the United States. Here the United States failed to comply with the ordinary rules governing the duties of senior lienholders. Congress could hardly have intended to condone on the part of the government this conduct which courts of equity have for centuries condemned.

Conclusion

For the reasons given the Petition for a Writ of Certiorari should be denied.

Respectfully submitted,

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